Taxation

1. Introduction

1.1. Chapter overview

This chapter mostly focuses on the taxation of UK individuals with the taxation of UK companies mentioned very briefly.

In this chapter we will look at three main areas:

- How UK individuals are taxed
- How financial products are taxed (tax wrappers)
- Tax planning

The types of tax that we will discuss are as follows:

- Income tax
- Capital gains tax
- Inheritance tax
- Corporation tax
- Stamp duty reserve tax

Before we start it is important to note that this version of the Fitch Learning Unit 1 IMC – Investment Environment manual is valid for exams from 1 December 2014. Exams taken from this date will be tested on the tax year 2014/15.

This chapter is often the one area that many delegates have not seen before. It is one of the most useful topics to cover as tax affects us all. The main advice in studying for this chapter is as follows:

- There will be tax calculations in the Unit 1 IMC exam, but the majority of the questions will be testing the understanding of the concepts, so pay more attention to the facts in this chapter
- It is helpful to focus on tax from a client's point of view, as many of the questions will look at tax from a tax planning perspective
- Think about your own tax situation - it can help to use your situation as a real example and think how the rules apply to you
- Finally, you are not expected to be a tax accountant to answer the questions in this section, nor should this chapter be taken as a complete guide to tax law. A sound understanding of concepts and an ability to calculate basic tax liabilities is required

1.2. Learning outcomes

On completion of this module you will:

Introduction to UK taxation for individuals

- 6.1.8 Explain the implications of residence and domicile in relation to liability to income, capital gains and inheritance tax

- 6.1.9 Describe the system of UK tax compliance including self assessment, Pay As You Earn (PAYE), tax returns, tax payments, tax evasion and avoidance issues

Income tax

- 6.1.1 Describe the principles of income tax applicable to earnings, savings and investment income in the UK
- 6.1.2 Describe, in relation to income tax, the system of allowances, reliefs and priorities for taxing income
- 6.1.3 Explain the taxation of the income of trusts and beneficiaries

National Insurance

- 6.1.4 Describe the system of national insurance contributions (NICs)

Capital gains tax (CGT)

- 6.1.5 Describe the principles of capital gains tax (CGT) in the UK

Inheritance tax (IHT)

- 6.1.6 Describe the principles of inheritance tax (IHT)
- 6.1.7 Explain the limitations of lifetime gifts and transfers at death in mitigating IHT

Taxation of investment income

- 6.1.14 Analyse the taxation of direct investments including cash and cash equivalents, fixed interest securities, equities and property
- 5.7.6 Explain the taxation of the various types of funds in the UK

Stamp duty

- 6.1.10 Describe the principles of stamp duty land tax (SDLT) as applied to property transactions buying, selling and leasing
- 6.1.11 Describe the principles of stamp duty reserve tax (SDRT)

Corporation tax

- 6.1.12 Explain how companies are taxed in the UK

Value added tax (VAT)

- 6.1.13 Describe, in outline, the principles of Value Added Tax (VAT)

Tax wrappers

- 6.1.15 Analyse the key features and taxation of indirect investments including pension arrangements, New Individual Savings Accounts (NISAs), Junior ISAs and Child Trust Funds, onshore and offshore life assurance policies, Real Estate Investment Trusts (REITs), Venture Capital Trusts (VCTs) and Enterprise Investment Schemes (EISs)

Tax planning

- 6.2.1 Evaluate the tax considerations shaping clients' needs and circumstances
- 6.2.2 Analyse the key principles of income tax planning
- 6.2.3 Analyse how the use of annual CGT exemptions, the realisation of losses, the timing of disposals, and sale and repurchase of similar assets can mitigate CGT
- 6.2.4 Calculate the most common elements of income tax and NICs, CGT, and IHT, including the impact of lifetime transfers and transfers at death
- 6.2.5 Select elementary tax planning recommendations in the context of investments and pensions advice

2. Introduction to UK taxation for individuals

2.1. The tax year and the financial year

The tax year (or fiscal year) relates to individuals and the financial year relates to companies.

The tax year starts on 6 April one year, and ends on 5 April the next year.

Tax year = 6 April to 5 April

Each tax year has its own set of tax rules that apply to UK individuals during the tax year.

Proposed changes to the tax rules are announced in the autumn Pre-budget Report by the Chancellor, and then finalised in the actual budget statement in March. This provides an opportunity for consultation with interested parties, meaning that proposals for change can be amended if necessary.

The finalised Budget changes are implemented by the passing of the Finance Act each year that makes the changes to UK tax law.

The tax year is very important in financial planning for the following reasons:

- Individuals are assessed on their total income received during each tax year for income tax
- Individuals are assessed on any capital gains made during each tax year for capital gains tax
- Each tax year brings new allowances for UK individuals such as a new personal allowance and a new capital gains tax allowance
- Changes to financial products are often made and come into effect in a new tax year

The financial year relates to companies and provides the tax rates, rules and allowance for UK companies for a 12-month period.

The financial year starts on 1 April one year, and ends on 31 March the next year.

Financial year = 1 April to 31 March

We will return to UK companies later in the chapter.

2.2. Residence

Whether a person is resident in the UK is vital to how income tax and capital gains tax will be charged on that individual. Her Majesty's Revenue and Customs (HMRC) have created a thorough test to assess whether a person is resident in the UK or not. This test comprises two categorical statements – 'automatic overseas resident' and 'automatic UK resident' – and a sufficient ties test for those that do not meet the categorical statements.

Automatic Overseas Resident

To qualify as automatic overseas resident there are three tests, and an individual need only meet one of these:

First overseas test

- An individual is present in the UK for fewer than 16 days in a fiscal year

Second overseas test

- If an individual has not bee present in the UK during the previous three years, and are present in the UK for fewer than 46 days in this fiscal year

Third overseas test

- An individual works full-time overseas. They must not have a place of residence in the UK available to them for more than 90 days and must spend no more than 30 days working in the UK

Meeting any of these three tests will qualify the individual as automatically resident.

Automatic UK Resident

An individual can qualify automatically as a UK resident is the meet one of the following three tests:

First UK resident test

- An individual is present in the UK for at least 183 days in a fiscal year

Second UK resident test

- The individual's only (or main) home is in the UK. This home must be available to them for 91 days or more and must be used for at least 30 days

Third UK resident test

- An individual works full-time in the UK

Sufficient ties test

If an individual meets neither of the automatic tests, they should apply the sufficient ties test to assess whether they are UK resident or not. This test is based on any ties an individual may have in the UK. These ties are:

- Family tie
- Accommodation tie
- Work tie
- 90-day tie

The finer details of the sufficient ties test are not test in the IMC syllabus.

2.3. Domicile

The concept of residency is based on the amount of time that an individual spends in the UK or the ties that an individual leaves in the UK. Domicile is a different concept; it is not based on residence, nationality or citizenship of an individual.

Domicile is considered to be where the individual ‘belongs’. An individual can be resident in more than one country. However an individual can only be domiciled in one country at a time.

UK tax law has various different versions of domicile:

- Domicile of origin which is acquired at birth, normally from the individual's father. It does not have to be the country in which the individual was born
- Domicile of choice. A domicile of choice cannot be acquired until the individual is at least 16 years old. Even then changing one's domicile is not straightforward. It involves the individual cutting links with their former domicile and settling permanently in the new country. HMRC will review the facts of each case

Domicile is important in determining the basis of income tax. It is also important in determining the liability to inheritance tax.

Income tax basis

The general rule is that an individual is liable to income tax on his worldwide income, i.e. income earned in the UK and overseas. The table below summarises any deviations from this general rule.

Table 11. Domicile summary

Status	Liability
UK resident	Worldwide income and gains on an arising basis.
UK resident but non-UK domiciled	UK income and gains on an arising basis. Overseas income and gains on an arising basis or on a remittance basis.
Overseas resident	UK income on an arising basis. Overseas income is not subject to tax.

The basic rule to remember is that an individual will be liable to tax on income earned in the UK regardless of their status.

Remittance basis

Some non-domicile residents can opt to pay UK tax on a remittance basis. This means their UK income and gains will be taxed as normal, but their overseas income and gains will be taxed only if they bring the money in to the UK. Generally, remittance basis taxation would involve reclaiming tax from Her Majesty’s Revenue and Customs (HMRC).

There are additional rules for long-term residents of the UK. If the individual is resident in the UK for seven out of the past ten years, they may have to pay a remittance basis charge (RBC) if they want their overseas income and gains to be taxed on a remittance basis. The RDC is an annual charge of £30,000 that compensates HMRC partially for the lost revenue from this resident.

Where the individual is resident for longer than 12 out of the last 14, the RBC increases to £50,000 per year.

A non-domicile UK resident would neither need to reclaim tax from HMRC nor pay the RBC if their overseas income did not exceed £2,000 in any fiscal year.

2.4. Collecting tax

Income tax is collected in three ways:

- Tax on non-savings income from employees is collected under the pay as you earn (PAYE) system
- Tax on non-savings income from the self-employed is collected twice a year by payments on account
- Tax on savings income and dividend income, and property income is collected under self-assessment via a tax return

Think about this for a moment. The tax authorities ensure our earned income is fully taxed, so how do they ensure our savings and investments are taxed – they need us to declare to them what investment income we receive each tax year on a tax return.

Tax returns are sent to certain individuals at the end of each tax year to remind them that it is their responsibility to complete it and pay any tax due. Not every individual will receive a tax return as not everyone has additional tax to pay on their savings and investments. Higher rate taxpayers will be the main category of individual that will receive a tax return, but also those who receive gross income, from property of gilts, for example, or those who have capital gains above the annual exemption

Self-assessment

In this section we discuss how an individual is required to pay their tax through the UK self-assessment system administered by Her Majesty's Revenue and Customs (HMRC).

Self-assessment for employees

The majority of employees pay their income tax through the pay as you earn (PAYE) system. Basic rate income tax on savings income is deducted at source by banks and building societies. Some higher rate taxpayers will be required to complete a tax return if they have significant investment income or income from other sources (such as rental income).

Any records must be retained for six years.

Payments on account

Some individuals are required by HMRC to make instalment payments. This applies to the self-employed and individuals who paid less than 80% of last year's income tax at source.

The payments for 2014/15 are due on the following dates:

- 31 January 2015
- 31 July 2015

The payment is calculated as 50% of the previous year's income tax liability. If the payments are insufficient to meet this year's liability a sweep-up payment is due on 31 January 2016 (including any capital gains tax due).

Tax return deadline dates

The self-assessment system requires the individual to submit details of their income for the fiscal year and to keep sufficient records to justify it (if required to do so by HMRC). Records need to be kept for 22 months after the end of the relevant fiscal year.

The deadlines for submission of the 2014/15 tax return are as follows:

- Taxpayer submits details of their income and gains for the year and HMRC calculates the tax payable or repayable – 31 October 2015
- Taxpayer submits their return and calculates the tax liability themselves – 31 January 2016

For employees who submit their returns by 31 October any further tax due is collected through PAYE. For other individuals the tax is due by 31 January 2016.

Failure to submit a return by the deadline results in a fine of £100.

The advent of online return submissions has made the tax return process much more straightforward for the majority of taxpayers as the calculation of the tax liability is done automatically.

2.5. Important dates in the UK tax calendar

6 April – start of a new tax year.

5 April – end of the tax year. Higher rate taxpayers are sent their tax returns to be completed, received and paid by 31 January next year.

31 October – individuals can ask HM Revenue & Customs to calculate their tax due for free until 31 October each year.

Alternatively you can fill it in yourself, do it online or pay an accountant to do it for you.

31 January – tax returns must be received by the following 31 January or a late penalty will be due. All tax due in a tax year must also be paid by this date or else interest will start accruing. In our example of the 2014/15 tax year, tax must be paid by 31 January 2016.

3. Income tax

3.1. Types of income

We can separate an individual's income into three categories:

- Non-savings income
- Savings income
- Dividend income

Non-savings income

The two main categories of non-savings income are:

- Income form employment
- Property income

Income from employment

Income from employment can also be assessed in two parts:

- Employed
- Self-employed

Employees – have income tax deducted by the employers via the pay as you earn (PAYE). This means that employees will have paid all income tax due on their earnings automatically each tax year.

Note that employees may have savings and dividend income as well – see below.

Self-employed – have no income tax deducted by their customers and so are paid gross. They need to complete a tax return to tell the tax authorities how much tax they are due to pay. The self-employed pay their tax twice a year in January within the tax year to which it applies and in July after the tax year has ended. These are termed 'payments on account'.

Property income

Income from property comprises the following types of income:

- Income from commercial property (direct property investment)
- Incomes from a real estate investment trust (indirect property investment)

We will see later in this chapter that income from non-savings uses the following tax rates 20%, 40% and 45%.

Under 'rent a room relief' an individual can rent out a room in heir primary residence and receive up to £4,250 per tax year tax-free. Rent received above this limit will be taxed at either 20%, 40% or 45% depending upon the level of an individual's statutory total income.

It is also worth mentioning that distribution from real-estate investment trusts (REITs) are also classed as property income distributions (PIDs) and are taxed at this level.

Savings income

Individuals may well receive income from their savings. Most savings income is taxable.

Dividend income

Individuals may receive income from their equity investments. Most dividend income is taxable.

Dividend income – income from dividends from UK companies. Dividends received from UK companies come with a 10% tax credit. This is because when UK companies declare a dividend they pay these dividends out of profits after tax.

As we will see later in this chapter, this 10% tax credit meets the dividend tax liability for basic rate taxpayers. Higher and additional rate taxpayers still have more tax to pay over and above this 10% on UK dividends.

3.2. Statutory total income

As we have seen, an individual may have a number of sources of income such as:

- Non-savings income – this is taxed first
- Savings income – this is taxed second
- Dividend income – this is taxed third

Income from these sources is added together to find an individual's statutory total income.

Note that income is taxed in the order shown above, starting with earned income. It is important to note the following:

- Each source of income has its own rates of tax – see below
- All sources of income use the same tax bands e.g. if an individual has statutory total income from any source above £31,865 they will be a higher rate taxpayer and pay higher rate tax on each £1 above this threshold

A higher rate taxpayer will generally pay higher rate tax at 40% on each £1 above this higher rate threshold of £31,865, except for dividend income that has a different higher rate tax rate:

- Non-savings income – higher rate tax = 40%
- Savings income – higher rate tax = 40%
- Dividend income – higher rate tax = 32.5%

It is worth noting at this stage that there is an **additional rate of tax** for those earning more than £150,000. This rate is 45% for non-savings, and savings income and 37.5% for dividend income.

Reducing total statutory income

Total statutory income can be reduced through certain payments. Primarily:

- Pension contributions – subject to a basic amount of £3,600 and a maximum amount of £40,000 per year
- Donations to charity

Table 12. Income tax rates summary for FY 14/15

2013/4	Non-Savings income	Savings income	Dividend income
Starting rate for savings: £0-£2,880	N/A	10%	N/A
Basic rate: £0-£31,865	20%	20%	10%
Higher rate: £31,866-£150,000	40%	40%	32.5%
Additional rate: over £150,000	45%	45%	37.5%

3.3. Tax rates and the personal allowance

Notice that the income tax rates on our earned income are different from the income tax rates on our savings income and on our dividend income in the 2014/15 tax year.

Let's start with looking in more detail at our earned income and we will return to any savings and dividend income later.

Earned income includes:

- Money received – salary, overtime, bonuses, commission, profit share, etc
- Benefits received – the monetary value of these benefits is called ‘benefits in kind’ e.g. company car, health insurance, preferential loans, etc.

The income tax personal allowance

Every UK resident is entitled to a new personal allowance each tax year. The personal allowance is an amount of income that can be earned tax-free each tax year. Once an individual's income exceeds this personal allowance then every additional pound over the personal allowance starts incurring income tax.

Note that the first three digits of the personal allowance form an individual's tax code.

The personal allowance increases for those under age 65 is £10,000.

Reduction of personal allowance

This personal allowance is, however, at risk for high income earners. Once an individual's income reaches £100,000, the personal allowance begins to be taken away at a rate of £1 for every £2 earned above that figure.

This means, for FY 14/15, anyone earning £120,000 or more has no personal allowance at all.

3.4. Calculation of income tax

In the UK our non-savings income is potentially taxed at four rates – 45%, 40%, 20% and 0%.

The following examples will illustrate how each tax band works:

Example 1:

Denise, aged 25, has a part time job and earns £10,560 pa. What income tax will she pay?

Denise pays no tax on her first £10,000, as this is the tax free personal allowance. This leaves £560 of Denise's income to be taxed at the 20% (basic rate) band.

Denise's total tax will be:

Table 13. Denise tax example

Total income	£10,560		
Personal allowance	(10,000)	@ nil%	= £0
Taxable income	£560	@ 20%	= £120
Total tax			**£120**

Example 2:

Holly, aged 33, earns £75,000 pa. What income tax will she pay?

Holly’s income tax can be calculated as follows:

Table 14. Holly tax example

Total income	£75,000		
Personal allowance	(10,000)	@ nil%	= £0
Taxable income	£65,000		
Basic rate	(£31,865)	@ 20%	= £6,373
Higher rate	33,135	@ 40%	= £13,254
Total tax			**£19,627**

Taxation of property income

Income from property is looked at alongside non-savings income.

Income from commercial property and real estate investment trusts (REITs) are taxed at either 45%, 40% or 20%.

It is allowable to offset certain costs and expenses against property income, such as loan interest costs.

Assessing income for self employed or partnerships

When assessing income for the self-employed and partnerships, tax is paid on net income. Net income can be reduced with **deductible interest**.

Deductible interest can be used if the loan is in relation to qualifying purposes. These include:

- Investing in a partnership or co-operative
- Buying an interest in business assets, such as plant or machinery, or an unquoted employee controlled company

3.5. Taxation of trusts

Trusts are subject to income tax and the trustee is responsible for meeting the tax liabilities of the trust. These tax liabilities will be paid out of the trust assets. However, trusts are not taxed in the same way as individuals.

For most trusts, the first £1,000 of income is taxed at the basic rate of tax: 20% for savings and property income and 10% for dividend income. This is called the **standard rate band**.

Any income above £1,000 is taxed at the additional rate: 40% for savings and property income and 37.5% for dividend income. This is referred to as the **trust rate** (dividend trust rate when referring to dividend income).

The sequence of assessing income is the same as for individuals: non-dividend income first and dividend income last.

It is also worth emphasising that the £1,000 standard rate band is based on the settler, not the trust. If an individual sets up two trusts, the standard rate band is £500 for each trust.

Where a beneficiary receives income from the trust, they will receive that income net of the rate paid by the trust. As this is the additional rate of tax for any trust generating income above £1,000, there is the possibility that the beneficiary may need to reclaim tax from Her Majesty's Revenue and Customs (HMRC).

Bare trusts

Bare trust give absolute vested interest in the assets to the beneficiaries. For the taxation of these trusts, the trust is ignored. Instead the tax is paid at the beneficiaries marginal rate of tax. This tax charge is liable on the trust asset, whether the income is paid out or not.

4. National Insurance

4.1. Who pays National Insurance?

National Insurance contributions are paid by employees and the self-employed once aged 16 and over, as long as their earnings are more than a certain level.

State benefits that are linked to your National Insurance contributions are known as 'contributory benefits'. Notably, these benefits include the State Pension.

State Pension age is 65 for men born before 6 April 1959 and 60 for women born before 6 April 1950. But it will gradually increase to 65 for women by 2018. It is proposed that both men and women will then have a State Pension age of 66 by 2020.

4.2. What type of National Insurance do you pay?

The amount and type of National Insurance Contributions (NICs) paid depends on whether an individual is employed or self-employed and how much they earn.

For those employed – Class 1

An employed person pays Class 1A NICs.

Contributions are deducted from your wages by your employer.

The employer also contributes Class 1B NICs.

For those self-employed – Class 2 and Class 4

A self-employed person pays Class 2 and Class 4 National Insurance contributions.

- Class 2 NICs are paid at a flat rate
- Class 4 NICs are paid as a percentage of annual taxable profits

Voluntary National Insurance contributions

Some people also pay voluntary NICs. For example, an individual might choose to pay them if they:

- Are not working and are not claiming state benefits
- Have not paid enough NICs in a year to count for the State Pension or other long-term state benefits
- Live abroad and want to maintain their state benefits entitlement

Class 3 voluntary contributions are paid either monthly by Direct Debit or by quarterly bill. But if you have gaps in your National Insurance contributions record you can make one-off payments of voluntary contributions to fill these.

As a rule of thumb, an individual will need to have made 30 years worth of NICs to qualify for the full state pension.

5. Capital gains tax

5.1. Introduction to capital gains tax

We have looked already at the taxation of income; we now move on to the taxation of capital gains.

Here are some important facts to remember:

- A UK resident is liable for capital gains tax on gains arising anywhere in the world
- Each UK resident has a new CGT allowance each tax year (£11,000 2014/15)
- Capital losses made in any one year can be carried forward indefinitely to set against future gains
- There is no capital gains tax on qualifying bonds (bonds that pay coupons) – this includes gilts, corporate bonds, local authority bonds, PIBS etc.

5.2. Calculation of a capital gain

Overview

For the exam you need to understand an overview of how to calculate a capital gain as well as perform the actual calculations. We will show a detailed example just to illustrate how it works.

Before we calculate a capital gain it is important that you are familiar with:

- Annual CGT exemption
- The rates of CGT

Annual capital gains tax exemption

There is also an annual capital gains tax exemption (£11,000 in 2014/15).

Every UK resident receives a new CGT exemption each tax year, but it is a ‘use it or lose it’ exemption; unused exemptions cannot be carried forward.

Only capital gains above £11,000 each tax year are chargeable to capital gains tax. Remember that this exemption is applied after any gain has been reduced by other costs and losses.

The process of assessing the amount liable to CGT is as follows:

- Proceeds on disposal
- Reduced by:
  - Cost of asset
  - Losses carried forward
  - Any other allowable costs
  - The CGT annual exemption
- Capital gains tax is now chargeable

Capital gains tax exemption – for married couples and civil partners

A transfer between spouses or civil partners is not a chargeable transfer in respect of CGT. This means that if spouses or civil partners transfer assets to each other, it will not incur CGT.

This leads to a common tax planning strategy. If an asset was held in the name of one spouse, they can add on the other spouse to the register of owners before they sell the asset. This will allow the investors to benefit from two lots of CGT exemptions i.e. 2 x £11,000 = £22,000.

Unmarried couples are not able to do this.

Capital gains tax rates

If a capital gain still exists after all of the costs and allowances described, it is taxed at a flat rate of 18%. For higher and additional rate taxpayers the rate is 28%.

The only exception to these rates is on disposal of certain business assets. This will attract entrepreneurs' relief, which results in an effective rate of CGT at 10%.

Calculation of capital gains tax

Mary bought an asset for £12,000 in 2008. She sells it in FY14/15 for £28,000. She also sold another asset at a loss of £1,000 in the same year. As a higher rate taxpayer, what is her CGT liability?

Table 15. Calculation of CGT

	£	**Tax liability**
Proceeds from main asset	28,000	
Cost of asset	(12,000)	
Capital gain	16,000	
Capital loss in same year	(1,000)	
Annual exemption	(11,000)	
Taxable gain	4,000	@ **28% = £1,120**

Capital gains tax on other assets

Here is quick summary of the assets to which CGT is and is not due:

Table 16. CGT on assets summary

Exempt assets include:	Primary residence
	Betting and Lottery wins
	Shares in enterprise investment fund schemes and seed enterprise investment schemes sold for the first time, having been held for the relevant holding period
	Gilts and qualifying bonds
	National savings certificates and premium bonds
	Private motor cars
	Life assurance policies
	Currency bought for holidays
	Gifts to charities
Liable assets include:	Company shares and non-qualifying bonds
	Second property or an subsequent properties
	Other chattels above £6,000 – antiques, art, stamps, etc.
	Currency bought and sold for gain
	Units in CIS

Capital gains tax and NISA wrappers

Shares, collective investment schemes and property can all be NISA wrapped - meaning that they would not be subject to capital gains tax.

This is a considerable benefit over time as each year more and more of a client's portfolio can be NISA wrapped.

6. Inheritance Tax

6.1. Overview

Inheritance tax (IHT) is mostly a tax on assets on death, but there is one situation where IHT is payable in life as we will see shortly. Chargeable persons are considered not on residence, as we saw for income tax and capital gains tax, but on domicile.

6.2. Three types of transfer

There are three types of transfer relating to inheritance tax:

- Potentially exempt transfers
- Chargeable lifetime transfers
- Exempt transfers

Potentially exempt transfers

When a gift is made to another person (in excess of the nil-rate band) it is termed a 'potentially exempt transfer'. It is potentially exempt because the donor (the giver) needs to survive seven years from the date of the gift, or else some inheritance tax will be due to be payable on this gift (by the receiver).

This seven-year rule in the field of inheritance tax is called the 'seven-year clock'. It is designed to stop individuals trying to give away assets just before their death to avoid paying inheritance tax. The result of the seven-year clock is that to legally avoid paying inheritance tax, assets should be given away earlier in life when the donor is in good health.

On death, Her Majesty's Revenue and Customs (HMRC) looks back seven years to find any potentially exempt transfers. Remember that transfers totalling less than £325,000 are exempt.

Chargeable lifetime transfers

Almost all transfers are 'potentially exempt'. However, a transfer into a discretionary trust is deemed a chargeable lifetime transfer. This will incur an immediate IHT charge of 20%, and could be liable for more if the donor dies within seven years of the gift.

Exempt transfers

There are a number of transfers that are totally exempt from inheritance tax:

- Individual's annual IHT exemption - £3,000 per tax year. If not used this can be carried forward one year only (giving a potential maximum of £6,000 in any single year)
- Gifts in contemplation of marriage - gifts to a bride and groom are exempt to these limits: parents, £5,000; grandparents, £2,500; anyone else, £1,000
- Transfers between spouses and civil partners - fully exempt unless one spouse is a non-UK domicile then a £55,000 limit applies
- Transfers to charities - exempt from IHT. If more than 10% of the estate is left to charity, the IHT rate is reduced by 10% to 36% for the remainder of the estate

6.3. Calculation of inheritance tax

Inheritance tax is payable on the value of a deceased person's estate. All a deceased person's assets are valued and any liabilities are deducted.

Each UK domiciled individual receives the nil-rate band of inheritance tax, currently £325,000. This means that the first £325,000 of an estate is charged at 0%. Inheritance tax is then charged on the excess above the nil-rate band at 40%.

6.4. Gifting the nil-rate band

The unused percentage of the nil-rate band can be transferred between spouses and civil partners. This works as follows:

- If one spouse of a married couple died in July 2012 and did not use their nil-rate band at all, then 100% of it is available to the other spouse on their death whenever that occurs. If, for example, the other spouse dies five years later when the nil-rate band has risen to £350,000, the other spouse will receive both their own and their deceased spouse’s nil-rate band of £350,000 + £350,000 = £700,000.

- If part of the nil-rate band has been used then the unused percentage can be transferred in the same way.

- This change has effectively given married couples and civil partners up to £650,000 (2 x the nil-rate band) of IHT protection without the need to pay solicitors to set up a tax efficient will.

Non-married couples do not benefit from this change.

6.5. Gifts with reservation

Under the rules of inheritance tax it is not possible to ‘pretend to give away’ assets and keep using them as your own.

This is called a ‘gift with reservation of benefit’. It occurs when the giver (the donor) of an asset is still able to use the asset for free i.e. still gaining a benefit from the asset.

A good example is an expensive family home. Imagine an expensive family home that is valued well over the combined nil-rate band of £650,000 and likely to incur quite a sizeable IHT bill. What if the parents decided to gift this home to their children and yet still live in the home themselves?

If the parents continue to live in the house as before then the tax authorities would class the gift as a gift with reservation – because they are still obtaining the benefit from their home by living in it. This means that the seven-year clock mentioned above will not start ticking, and on death of the parents the house will be included within their assets for IHT purposes.

On the other hand, if the parents were to pay a market rent, this would not be a gift with reservation and the seven year clock would start ticking. Note that the amount of the asset above the nil rate band would be classed as a PET – meaning that the parents would need to survive seven years or some IHT would be payable on their early death.

7. Taxation of investments

7.1. Summary

Taxation of direct investments

Table 17. Taxation of direct investments

	Income	Capital	Withholding	Stamp duty
Cash	Yes	No	20%	No
NS&I	Variable	No	Variable	No
Gilts	Yes	No	No	No
Corp. Debt (qualifying)	Yes	No	20%	No
Corp. Debt (convertible)	Yes	Yes	20%	Yes
Equity	Yes	Yes	10%	Yes
Property (primary res.)	N/A*	No	N/A	Yes
Property (investment)	Yes	Yes	No	Yes
Chattles	No	Yes†	N/A	No

* Rent-a-room scheme allows £4,250 p.a. tax-free

† Chattles below £6,000 in value are tax free

Taxation for indirect investment

From the perspective of the fund managing the portfolio, the tax liabilities are as follows:

Table 18.

	Income	Capital gain	Stamp duty
Equity CIS	Yes at 20%	No	Yes
Debt CIS	Yes at 20%	No	Yes (on equity)
ITC	CT rate applicable	No	Yes
REIT	No	No	Yes (SDLT)
VCT	CT rate applicable	No	Yes

From the perspective of the investor, who has invested in the fund, the tax liabilities are as follows:

Table 19.

	Income	Withholding tax	Capital gain	Stamp duty
Equity CIS	Yes (Div)	Yes 10%	Yes	No
Debt CIS	Yes (Sav)	Yes 20%	Yes	No

	Income	Withholding tax	Capital gain	Stamp duty
ITC	Yes (Div)	Yes 10%	Yes	Yes
REIT	Yes (Sav)	No	Yes	Yes
VCT	No	N/A	No	Yes

CIS = collective investment scheme including unit trust and investment company with variable capital (ICVC)

ITC = investment trust company

REIT = real estate investment trust company

VCT = venture capital trust

What if income is not paid out, but is reinvested in the CIS?

Sometimes income from a collective investment scheme is not paid out to the investor but instead is reinvested to purchase more units/shares in the fund. How is this taxed (as the investor has not received it)?

Although the investor has not received it through the post or in their bank account, their fund has received it so they are taxed on income reinvested back into their fund each tax year. The investor will receive a statement from the company detailing how much income has been reinvested to enable them to declare this on their tax return.

8. Stamp Duty

8.1. Stamp duty reserve tax

Introduction

Stamp duty is a form of UK taxation payable on transfers of assets such as real estate and certain securities.

In relation to securities, **stamp duty** is payable on **certificated** shares. Traditionally the transfer document is stamped in order to evidence the payment of the tax.

More typically nowadays, there is no transfer document as shares are held in dematerialised (electronic) form. For transfers on these securities, the tax is known as **stamp duty reserve tax** (SDRT). SDRT is payable on:

- Securities held within CREST (e.g. company shares)
- Options on company shares
- Purchases of renounceable letters of acceptance
- Shares purchased and re-sold the same day
- UK convertible loan stock

It is only the **buyer** of the securities who is liable to pay the tax.

Exempt investments

Stamp duty or SDRT is not payable on the following investments:

- Gilts
- Corporate bonds (including eurobonds) and debentures (unless convertible)
- Units in unit trusts
- OEIC shares

Note: stamp duty is only paid on the purchase of the underlying shares in unit trusts/OEICs, not on buying into the unit trusts/OEIC itself.

Other exempt transfers

The following transfers are also exempt from both stamp duty and SDRT:

- Bearer securities
- Overseas securities
- New issues

The following persons are exempt from both stamp duty and SDRT:

- Recipients of gifts

- Registered charities
- LSE member firms (who are not fund managers) and are granted intermediary status by the LSE e.g. market makers

Stamp duty reserve tax (SDRT) rate

The rate of taxation is the same for both stamp duty and SDRT (0.5%), and is rounded to the **nearest penny**.

8.2. Stamp duty land tax (SDLT)

Overview

SDLT is a transaction tax on land in the UK; it is a charge on documents that transfer property.

Unlike most modern taxes SDLT is not collected directly from taxpayers by assessment. The purchaser of land is responsible for making a land transaction return and paying the SDLT within 30 days of the effective date of the transaction.

The rate of tax is a percentage of the purchase consideration for the transaction (rounded-down to the nearest pound). SDLT on residential land or property - freehold or leasehold – is as follows:

Table 20. SDLT rates summary for residential property

Purchase price/lease premium or transfer value	SDLT rate
Up to £125,000	Zero
£125,001 to £250,000	1%
£250,001 to £500,000	3%
£500,001 to £1,000,000	4%
£1,000,001 to £2,000,000	5%
Over £2,000,000*	7%

Notes

*If residential property purchased for more than £2,000,000 is bought by a non-natural person, for example a company, there is a special anti-avoidance SDLT of 15%.

SDLT for commercial property

Table 21. SDLT rates summary for commercial property

Purchase price/lease premium or transfer value	SDLT rate
Up to £150,000*	Zero
£150,001 to £250,000	1%
£250,001 to £500,000	3%
Above £500,000	4%

Notes

*The rate is 1% where the annual rent is £1,000 or more.

SDLT for leased property

SDLT for leased property is based on the net present value (NPV) of the lease. If this is below £125,000 for residential property or below £150,000 for commercial property, there will be 0% SDLT.

If the NPV is above £125,000 for residential property and above £150,000 for commercial property SDLT is 1% of the NPV.

9. Corporation tax

9.1. Overview

This chapter only contains a brief overview of corporation tax as the main focus is on personal tax planning.

As an introduction it is important to distinguish between limited companies, sole traders and partnerships. Only limited companies pay corporation tax based upon their business profits over a 12-month period (their financial year).

Corporation tax:

- Is self-assessed
- Most companies pay 9 months and 1 day after the end of their accounting period
- Large companies pay in 4 quarterly instalments

Profits made by sole traders and by partnerships are assessed against each individual's share in the business. This share of the profits is then taxed as income tax rather than corporation tax.

9.2. Companies chargeable

Corporation tax is payable by UK resident companies on their worldwide profits, and by companies resident overseas on their profits arising in the UK.

The tax is payable on income, such as operating profits and interest receivable, and gains, such as the profit arising from the sale of a building or shares.

9.3. Profits chargeable to corporation tax

Taxable profit or profits chargeable to corporation tax (PCTCT) is the amount on which corporation tax is calculated. It is not the same as the profit disclosed in the accounts. This is because the HMRC disallows for tax purposes certain items of expenditure, such as entertaining and depreciation. In place of depreciation they give a fixed rate allowance known as a capital allowance.

9.4. Corporation tax rates

There are two rates of corporation tax:

- The small company rate – profits up to £300,000 pay 20%.
- The main rate – profits over £1.5m pay 21%.
- There is a gradual transition from the 20% to the 21% rate of corporation tax as profits increase above £300,000. This transition is called marginal relief.

9.5. Losses

A company's trading losses can normally be set against:

- Income and gains of the same accounting period.
- Income and gains of the previous year.

- Trading profits from the same trade in future years.

Losses of the final 12 months of a trade can be carried back three years. Losses are set against more recent periods before earlier periods.

10. Value added tax (VAT)

10.1. Overview

VAT is a tax charged on the provision of many goods and services in the UK. It is designed to be a tax on the end consumer, i.e. a sales tax.

For VAT to be chargeable there has to be a taxable supply of goods or services by a taxable person in the course of business carried on by him.

A taxable supply includes goods and services in the UK and the importation of some goods.

A taxable person is a legal person (such as a company or sole trader) registered for VAT purposes.

The rules outlined below only apply in England, Scotland, Wales and Northern Ireland. The Isle of Man has a slightly different system and there are no sales taxes in the Channel Islands.

10.2. How does VAT work?

VAT is an ad valorem tax i.e. it is added to the sales price of goods and services. Not every good or service has VAT added to the price, only those goods or services which are deemed to be taxable supplies.

The detail of which supplies are or are not taxable is beyond the scope of the syllabus other than brokerage fees (see below). Supplies include items that are sold or gifted. Broadly there are three categories of supply:

Table 22. VAT summary

Taxable supplies	Rate of VAT charged
Standard-rated	20%
Zero-rated	0%
Reduced	5%

The type of supply is important because it determines whether a business can reclaim the VAT it has suffered on purchases.

Only those businesses making taxable supplies can reclaim VAT. A business making exempt supplies or supplies outside the scope of VAT cannot reclaim the VAT it has paid on purchases of goods and services. The rules on ‘exempt supplies’ typically includes charities, which results in charities paying VAT.

A business can only reclaim VAT if it is a taxable person. A taxable person is a business that is either making taxable supplies or intending to make taxable supplies over a certain threshold. Businesses can register voluntarily to charge VAT to allow themselves to reclaim the VAT they have suffered.

10.3. VAT for stock brokers

Services traditionally provided by stock brokers are classified differently for VAT purposes. The classifications are as follows:

Table 23. VAT for stock brokers

Type of service	Type of supply
Portfolio management fees	Standard rated
Advisory services	Standard rate but only if unbundled (i.e. invoiced separately)
Commissions	Exempt
Nominee services	Exempt

11. Tax wrappers

11.1. Overview

We have seen already that NISAs are a form of tax wrapper in that they wrap around many types of investment and make them much more tax efficient.

In this chapter we will look at the following tax wrappers:

- NISAs
- Child Trust Funds (CTFs) and Junior ISAs
- Life Company Funds
- Venture Capital Trusts (VCTs)
- Enterprise Investment Schemes (EISs)
- Pensions

Each of these tax wrappers have their own limits and key characteristics that are important to know for the exam.

11.2. New Individual Savings Accounts (NISAs)

New Individual Savings Accounts (ISA) have a big impact on investment income.

NISAs are not products themselves, they are tax wrappers. If someone says they have a NISA we would not know what type of investment they have other than it is wrapped in a NISA.

In the tax year 2014/15, £15,000 in total can be contributed to a NISA.

NISAs are very tax efficient but not always tax-free

In this chapter we have looked at three types of income:

- Non-savings income
- Savings income
- Dividend income

We can NISA wrap most of these incomes (with the exception of income generated through employment) which will make almost all the income received tax-free as follows:

Property income – all becomes tax-free

Income from REITs and from commercial property is tax-free when they are NISA wrapped.

The saving for each type of taxpayer is therefore:

- Additional rate taxpayer saves 45%
- Higher rate taxpayer saves 40%
- Basic rate taxpayer saves 20%

- Non-taxpayer does not save anything

Savings income – all becomes tax-free

Interest from cash deposits, from gilts, from bonds, from PIBS, from local authority bonds, from CIS (mostly in bonds), all become completely tax-free.

The saving for each type of taxpayer is therefore:

- Additional rate taxpayer saves 45%
- Higher rate taxpayer saves 40%
- Basic rate taxpayer saves 20%
- Lower rate taxpayer saves 10%
- Non-taxpayer does not save anything

Dividend income – a NISA cannot reclaim the 10% tax credit – but no further tax to pay

We know that when a company declares a dividend that the dividend is received net of a 10% tax credit. A NISA cannot reclaim this 10% tax. However, shares that are NISA wrapped do not have any extra income tax to pay.

This means that any investment directly in shares or indirectly via a CIS, that is NISA wrapped, is very tax efficient but not tax-free.

The saving for each taxpayer is therefore:

- Additional rate taxpayer saves 27.5%
- Higher rate taxpayer saves 22.5%
- Basic rate taxpayer, the lower rate taxpayer and the non-taxpayer do not save any more income tax because they only have 10% or 0% to pay in total

NISAs are also exempt from capital gains tax

Investments held in NISAs are also exempt from capital gains tax.

Other features of NISAs

Here is a summary of additional features of NISAs:

- NISAs can be transferred to other providers – this preserves the tax wrapper, but may incur transfer costs
- If the NISA investor moves abroad, the tax benefits remain, but they are no longer allowed to contribute to their NISA

Contributions to a NISA cannot exceed £15,000 for the tax year 2014/15. For example, if £15,000 is invested in May 2014 and later in November £1,000 is withdrawn, no more can be invested until the new tax year on 6 April 2015.

11.3. Junior ISAs

The government introduced Junior ISAs (JISAs) from 1 November 2011. These are available to children under the age of 18 who were either born after 2 January 2011 or who were not eligible for a Child Trust

Fund. Existing CTFs will continue to function for those eligible. For the purpose of the IMC exam, they have the same features as JISAs.

Overview

Here are the key features of JISAs:

- A JISA can be opened by anyone with parental responsibility for the child (or by children themselves from age 16)
- Maximum investment in a JISA is £4,000 per tax year which may be split between a cash JISA and a stocks and shares JISA
- One of each type of JISA can be opened per child
- Any income generated in an ISA that a parent has funded will not be taxable on that parent
- There is no access to the JISAs cash proceeds until the child's 18th birthday

11.4. Offshore funds

An offshore fund is essentially a unit trust, with the exception that it is domiciled overseas. As with a unit trust, investors' money is pooled and then invested in the shares of companies and/or other assets.

The fund itself also does not pay UK tax.

Offshore funds are classed as either reporting/distributor or non-reporting/non-distributor ('roll up funds').

Reporting funds

Distributor funds are those which have applied to HMRC for reporting status and report income. The distributions from such a fund are paid gross.

Distributor funds distribute at least 85% of their income.

Income is paid to investors gross and is treated as taxable income for UK residents. Any subsequent gains on the disposal of units are subject to capital gains tax.

Non-reporting funds ('roll up' funds)

Non-distributor funds distribute less than 85% of their income. They usually reinvest ('roll up') their income and do not pay dividends.

Gains on the disposal of units are subject to income tax, not capital gains tax.

11.5. Life Company Funds

Introduction

Life assurance companies do not just offer life protection, but also offer investments to their policyholders. These are often referred to as **life company bonds**, although these are not bonds like the debt instruments referred to earlier in the manual. Instead, these bonds are linked to a portfolio of assets and the income and gain on the bond is determined by the performance of the assets under managements.

These life company bonds can take the form of endowment policies, offering a basic sum assured on death of the policyholder or on maturity of the policy. Some offer a basic sum assured plus regular bonuses, referred to as with-profits bonds. Some simply offer the returns of a portfolio under management with no life assurance element, such as unit-linked bonds.

Since the introduction of ISAs (now NISAs), investments into life company funds have not been quite as popular. One of the reasons for this is that the taxation of an investment in a life company fund is not as attractive for investors as the taxation of a collective investment scheme held in an ISA.

Tax implications

An investment into a life company fund has 20% corporation tax deducted on income and gains made within the fund. This is different from investments in collective investment schemes that are exempt from tax on gains within the fund.

The 20% tax that has been deducted from a life fund cannot be reclaimed. There may also be additional tax to pay when an investor either cashes in their investment or dies – both of these events are termed 'chargeable events'.

It is termed a chargeable event because additional income tax may be chargeable for higher or additional rate taxpayers. Notice that this additional tax is actually income tax and not capital gains tax, therefore an individual cannot use their annual capital gains tax allowance to offset profits from Life Funds.

The Life Fund has already deducted 20% and, as some taxpayers are due to pay income tax at 40% or even 45%, they would be liable for an additional 20% or 25% income tax on gains made within their life fund. Lower and non-taxpayers cannot reclaim the 20% tax paid but would not have any more tax to pay.

Qualifying and single premium policies

There are two types of Life Company Policy: qualifying and single premium/non-qualifying policies.

Qualifying policies

Qualifying policies are investments into a life fund that meet the qualifying rules. If an investment meets these qualifying rules then there is **no further tax to be paid** on any pay out from the policy – even for higher and additional rate taxpayers.

To be a qualifying policy a policy must:

- Be a regular premium policy – at least annual premiums (normally monthly premiums)
- Have an initial term of ten years (must be kept for 3/4 of the term or ten years, whichever is the lower)

The most common kind of qualifying policy is an endowment policy. This is a regular premium into a life fund and meets all the qualifying rules. Endowment policies are used as savings plans, some of which aimed to build up enough of a value to repay a mortgage debt. However, investment returns are not guaranteed, and these policies can suffer shortfall risk.

Single premium/Non-qualifying policies

A single premium policy does not meet the qualifying rules. Any profits made from this policy will be taxable. An often quoted example is a simple premium life company bond. A portfolio-linked investment that tries to maximise returns over a medium to long period.

Remember that life funds have 20% tax deducted within the fund that cannot be reclaimed. Should an investor in a life fund cash in or die (both chargeable events) then higher rate taxpayers will have an extra 20% or 25% income tax to pay. Where qualifying policies have no more tax to pay, non-qualifying policies may incur this extra tax.

Examples of non-qualifying policies include lump sum investments into a life fund such as:

- Investment bonds/Insurance bonds
- Unit linked bonds and with profit bonds
- Distribution bonds

Withdrawals from Life Company Funds – the 5% rule

Introduction

When an investor makes a lump sum investment into, for example, a life company bond, there is a way to withdraw capital and defer tax liabilities on that withdrawal.

Withdrawals of up to 5% of the original capital invested can be made per year on a tax deferred basis. Tax deferred does not mean tax-free - instead these withdrawals are assessed for income tax when a chargeable event occurs, e.g. the investment is ultimately cashed in (or encashed) or the death of the policyholder.

Features

Here are the key features of this 5% withdrawal rule:

- It only applies to lump sum investments in life funds i.e. investment bonds, insurance bonds, with-profits bonds, unit linked bonds and distribution bonds
- Up to 5% of the original capital may be withdrawn each year on a cumulative basis and the income is tax deferred
- If more than 5% is withdrawn in any tax year, the withdrawal is classed as a chargeable event and higher rate tax payers are due an extra 20% and additional taxpayers a further 30% (remember a life fund has already deducted 20%)
- When the bond is ultimately encashed, the withdrawals and any gains are assessed together at this time and taxed as income

Tax advantage and risks

The idea behind this feature is that a higher or additional rate taxpayer (when they are of working age) who needs extra income could withdraw the 5% from their bond and not incur any income tax at this stage (tax deferred).

If in later years, once they have retired, their income drops and they become a basic rate taxpayer then when they encash their bond they may have no further income tax to pay because their tax rate has fallen.

If once the investor retires they are still a higher or additional rate taxpayer, then they would be liable to extra tax on any gains. Remember that gains on life funds are taxed as income tax.

Offshore life assurance bonds

Offshore life assurance bonds do not pay corporation tax on income and gains within the fund, although withholding tax on dividends is not reclaimable. This ‘gross roll-up’ of income and gains generally has the effect of causing the fund to grow more quickly than an onshore fund. Income withdrawals are achieved by selling units. Provided annual withdrawals do not exceed 5% of the initial investment, no liability to tax will arise until the bond is encashed in full. Withdrawals in excess of 5% per annum are liable to UK income tax at the taxpayer’s highest rate, as is the overall gain on final encashment. On final encashment, any ‘gain’ in the value of the investment bond (taking into account any previous withdrawals) is added on to the investor's income and is subject to tax in the normal way.

11.6. Venture Capital Trusts (VCTs)

Venture Capital Trusts (VCTs) are a type of Investment Trust that invests primarily in unquoted companies.

Venture capital is all about investing in small unproven companies with both great potential and high risk. As the government wants to encourage investments in such companies VCTs have a number of attractive tax benefits for investors.

There are significant tax benefits to investing in a Venture Capital Trust.

Income tax

- Maximum investment per tax year is £200,000
- Income tax relief is at 30% (if held for five years)
  - *Therefore the maximum income tax relief is the lower of an investor's total income tax liability and 30% of £200,000 i.e. £60,000*
- Dividends are tax free (no holding period requirement)

Capital gains tax

- No CGT is payable on disposals from a VCT (non holding period requirement)
- Losses are not allowable to use against gains

11.7. Enterprise Investment Schemes (EISs)

Enterprise Investment Schemes (EISs) also provide tax reliefs for investments in UK unquoted companies. EISs can only invest in companies with total assets no greater than £15m before the issue of shares.

This asset limit is called the Gross Assets Test and results in EIS investments only being allowed into fairly small companies. Note that Venture Capital Trusts typically invest in even smaller companies with even less of a track record.

Like VCTs investments in EISs have their own tax benefits.

Income tax

- Maximum investment per tax year is £1,000,000
- Minimum investment per tax year is £500
- Income tax relief is at 30% (if held for three years)
  - *Therefore the maximum income tax relief is the lower of an investor’s total income tax liability and 30% of £1,000,000 i.e. £300,000*
- Up to 100% of any investment into an EIS made each tax year may be ‘carried back’ to the previous tax year

Capital gains tax

- Investments in EIS schemes do not incur capital gains tax (if held for three years)

- Losses (after considering income tax relief) can be offset against income or other gains

Inheritance tax

- An EIS is exempt from inheritance tax

11.8. Seed Enterprise Investment Schemes

SEIS run alongside EIS. They are targeted specifically at start-up companies.

They offer:

- 50% income tax relief on up to £100,000 of investment per year
- Up to 50% of gains that are reinvested in a SEIS are exempt from CGT.

11.9. Pensions

Pensions have a very beneficial tax status in the UK. These tax benefits are as follows:

- Tax relief on each contribution at the investor's highest marginal tax rate. This means that for every £100 contribution to a pension a higher rate taxpayer pays £60 and a basic rate taxpayer pays £80
- Tax efficient funds, such as pension funds, pay no income tax or capital gains tax
- Up to 25% can be withdrawn as a **tax-free lump sum** on retirement. The rest of the pension fund must be taken as an income and is taxable as earned income

The main disadvantages of pensions are that your money is tied up and not accessible until later in life and that most of the pension fund must be taken as an income. This said, the tax benefits of pensions are very valuable in saving over the long-term for retirement.

The maximum contribution to a pension per tax year is the higher of:

- £3,600
- 100% of an investor's pre-tax earnings (up to a maximum of £40,000)

There is a maximum lifetime allowance of £1.25m. Any contributions above this will not benefit from the income tax relief.

12. Tax planning

12.1. The role of tax planning in financial advice

Financial advisors should take account of the client's personal tax position when considering the most suitable assets and tax wrappers to recommend.

We have seen the significant tax savings available by investing in tax wrappers such as NISAs, JISAs, CTFs and pensions to name a few. Other investments such as collective investment schemes allow the investor to use their annual capital gains tax allowances to carefully time when and how much of their investment to sell each tax year.

It is often said that 'the tax tail should not wag the investment dog', meaning that tax is only one of many factors involved in an investment decision. The client's objectives and their constraints should be as important as the tax treatment.

Clearly the advisor has a key role to play in the tax planning of investments. Moving on to the issue of inheritance tax, advisors have an equally important role to play in educating their clients in this largely unknown area of tax. With some advance planning significant sums of inheritance tax can be avoided and protected to pass on to future generations.

In real life, one issue is that not all advisors are trained and authorised in each financial planning area. Mortgage advisors concentrate on housing needs and investment advisors concentrate on investment needs. The result can be that some tax issues can be left unresolved and be ignored.

So to conclude, tax planning has a role to play in all aspects of financial advice.

12.2. Tax avoidance vs. tax evasion

It is important to understand the difference between tax avoidance and tax evasion:

- Tax avoidance – legally minimising tax liabilities
- Tax evasion – illegally hiding/not declaring the true nature of income and capital gains

Tax evasion incurs penalties and ultimately a prison sentence.

12.3. Ideas to minimise tax – tax avoidance

Here is a summary of some of the ideas we have looked at to help clients to legally minimise the tax that they pay:

- Use of the personal allowance £10,000 (2014/15), and ensuring non-taxpayers get to use their personal allowance each tax year by holding assets in their name
- Use spouse's personal allowance if not being used
- Use children's personal allowance if not being used. Note that if the gift comes from the parent of the child, the tax-free income is limited to £100 pa after which the income is taxed at the parents marginal rate. Income generated through gifts from other sources, grandparents, aunts and uncles, etc. benefit from the full allowance
- Choosing carefully who should own assets – thinking about their tax status

- Annual £15,000 NISA allowance – 'use it or lose it'
- Child Trust Funds and Junior ISAs – £4,000 per subscription year
- Pensions – employer schemes very valuable – if not available, use private pensions; perhaps a self-invested personal pension
- Annual CGT allowance can be used by investments in CISs e.g. Unit Trusts, OEICs and Investment Trusts
- Gains from direct share investments can also be realised if care is taken when reinvesting the gains
- EIS and VCT investments have many tax benefits
- Fixed income securities do not incur capital gains tax, only income tax on the coupons
- REITs and ETFs are also exempt from CGT within the fund
- Make a tax efficient will
- When the time is right consider gifting assets to family (potentially exempt transfers) either directly or via a trust to start the seven-year clock to legally avoid inheritance tax
- Use all available capital losses to offset against capital gains
- Remember the National Savings & Investments tax-free products such as index-linked savings certificates
- Important to have a financial review towards the end of each tax year/at the start of each tax year to understand how tax changes announced in the budget may impact on financial plans
- Married couples should consider gifting the nil-rate band to each other

12.4. Other tax planning issues

This chapter ends with an important section that is tested regularly. It is especially important that you are familiar with the international tax issues section that follows.

The two main tax issues covered in this section relate to the following:

- Parents giving money to children
- International tax issues

12.5. Transfer of Ownership

If one spouse is a higher rate taxpayer and the other spouse is having a career break, it makes sense to transfer ownership of investment capital, which generates taxable income into the name of the non-working spouse in order to make use of their personal allowance and their lower marginal rate of income tax.

The tax authorities are very cautious about parents that gift monies to children, as this may be used by parents as a way to evade tax themselves.

As a result if the monies given to children by their parents earn over £100 in income per tax year then the income is assessed as belonging to the parent. The implication of this is that parents cannot avoid tax by putting large sums of monies into their child's name.

Interestingly, gifts from grandparents or any other relative or person are fine. It is only gifts directly from parents that fall under this rule. It is also worth noting that children have their own personal allowance each tax year.

12.6. Strategies to mitigate Capital Gains Tax

- Spreading ownership of assets between family members to make use of the maximum number of annual exemptions. Transfers between partners are free from CGT
- Phasing encashments over several tax years if at all possible in order to access more than one annual exemption. For example, make two separate disposals in, say, late March 2014 (tax year 2013/14) and late April 2014 (tax year 2014/15), thus accessing two annual exemptions (rather than selling all of the investments in March 2014 and being entitled to only one annual exemption)
- Deliberately realising paper losses in order to reduce gains that would otherwise exceed the annual exemption and become taxable
- Deliberately realising gains within the annual exemption so that there is no actual taxable gain, then repurchasing a similar (but not identical) investment. This has the effect of increasing the base cost of the investment and thus reducing the risk of future gains exceeding future annual exemptions. Remember that any unused annual exemption cannot be carried forward. Purchasing back the same shares would be subject to the share matching rules and therefore taxable

12.7. International tax issues

Here is a quick recap of some of the key international tax issues that we have covered. These are regularly tested in the exam.

Residence

Definitions of residence – important for CGT and Income tax (see the start of the chapter for the definitions – it is important to know these).

A UK resident is liable to both income tax (on worldwide income) and capital gains tax (on worldwide gains).

A UK resident is entitled to a personal allowance for income tax, and an annual CGT exemption for CGT.

A non-UK resident is not entitled to these allowances.

Domicile

Domicile is important for IHT – your domicile is your permanent home.

A UK domiciled individual is liable for IHT on worldwide assets.

A non-UK domiciled individual is liable for IHT only on UK assets.

A non-domiciled spouse only receives £55,000 of the nil rate band of IHT.

Deemed domicile is gained after living in the UK for 17 of the last 20 years.

Other issues

The investor in a NISA cannot keep contributing to a NISA if they move abroad i.e. cease to be a UK resident. Their NISA does, however, still retain its tax benefits.

Investors in offshore funds with reporting status are taxed on gains as gains and income as income. Investors in offshore funds with non-reporting status are taxed on gains, and income as income.

13. Summary

13.1. Key concepts

Introduction to UK taxation for individuals

- 6.1.8 - The implications of residence and domicile in relation to liability to income, capital gains and inheritance tax
- 6.1.9 - The system of UK tax compliance including self assessment, Pay As You Earn (PAYE), tax returns, tax payments, tax evasion and avoidance issues

Income tax

- 6.1.1 - The principles of income tax applicable to earnings, savings and investment income in the UK
- 6.1.2 - In relation to income tax, the system of allowances, reliefs and priorities for taxing income
- 6.1.3 - The taxation of the income of trusts and beneficiaries

National Insurance

- 6.1.4 - The system of national insurance contributions (NICs)

Capital gains tax (CGT)

- 6.1.5 - The principles of capital gains tax (CGT) in the UK

Inheritance tax (IHT)

- 6.1.6 - The principles of inheritance tax (IHT)
- 6.1.7 - The limitations of lifetime gifts and transfers at death in mitigating IHT

Taxation of investment income

- 6.1.14 - The taxation of direct investments including cash and cash equivalents, fixed interest securities, equities and property
- 5.7.6 - The taxation of the various types of funds in the UK

Stamp duty

- 6.1.10 - The principles of stamp duty land tax (SDLT) as applied to property transactions buying, selling and leasing
- 6.1.11 - The principles of stamp duty reserve tax (SDRT)

Corporation tax

- 6.1.12 - How companies are taxed in the UK

Value added tax (VAT)

- 6.1.13 - In outline, the principles of Value Added Tax (VAT)

Tax wrappers

- 6.1.15 - The key features and taxation of indirect investments including pension arrangements, New Individual Savings Accounts (NISAs), Junior ISAs and Child Trust Funds, onshore and offshore life assurance policies, Real Estate Investment Trusts (REITs), Venture Capital Trusts (VCTs) and Enterprise Investment Schemes (EISs)

Tax planning

- 6.2.1 - The tax considerations shaping clients' needs and circumstances
- 6.2.2 - The key principles of income tax planning
- 6.2.3 - How the use of annual CGT exemptions, the realisation of losses, the timing of disposals, and sale and repurchase of similar assets can mitigate CGT
- 6.2.4 - The most common elements of income tax and NICs, CGT, and IHT, including the impact of lifetime transfers and transfers at death
- 6.2.5 - Elementary tax planning recommendations in the context of investments and pensions advice

Now you have finished this chapter you should attempt the chapter questions.