Tax wrappers

LEARNING OBJECTIVES

In this topic we look briefly at the way that the investment products we have considered in previous topics can be held within different tax wrappers. A tax wrapper is simply a tax shelter around an underlying investment that changes the way the investment is taxed. The most familiar of these is the individual savings account (ISA) in its various forms. Pensions are a form of tax wrapper too, but, as they are a topic in their own right, we cover them in Topic 10.

By the end of this topic you should have an understanding of:

- ISAs;
- Child Trust Funds and Junior ISAs;
- Venture Capital Trusts (VCTs);
- Enterprise Investment Scheme (EIS).

This topic covers the Unit 1 syllabus learning outcome U3.1 and 3.4.

THINK . . .

ISAs are one of most popular forms of savings account, so you have probably come across these before.

- If you have an ISA, do you hold your investments in cash or in stocks and shares? Or a combination of the two? Why did you make these decisions?
- Have you seen media coverage of the newer types of ISA, such as the innovative finance ISA, Lifetime ISA or Help-to-Buy ISA? What do you think of these initiatives?

Venture Capital Trusts and the Enterprise Investment Scheme are probably less familiar to you than ISAs, but you might have seen coverage in the financial media.

TAX WRAPPERS

In considering the different types of investment that can be held, either directly or indirectly, through collective investments, the tax treatment is an important factor. Tax can be charged at two stages in an investment's life:

- while the funds are invested;
- when funds are drawn or income is paid out.

The main taxes that affect investments are income tax and capital gains tax (CGT).

Using a tax wrapper, such as an ISA, changes the way the investor is taxed on income and gains from the underlying investment.

9.1 Individual savings accounts (ISAs)

In 1997, the government decided that the existing tax-free savings schemes were not sufficiently accessible to a large proportion of the population. At the time, it was estimated that 50 per cent of the population of the UK had less than £200 in savings, with about 25 per cent having no savings at all. The government subsequently introduced, from 6 April 1999, the individual savings account (ISA). Its stated objectives were to develop the savings habit and to ensure that tax relief on savings is fairly distributed.

9.1.1 Types of ISA

There are different types of ISA, with different types of underlying investment that can be held in each.

- A **stocks and shares ISA** can include:
  - shares and corporate bonds issued by companies listed on a recognised stock exchange anywhere in the world, including Alternative Investment Market (AIM) shares;
  - gilt-edged securities and similar stocks issued by governments of countries in the EEA;
  - UK-authorised unit trusts and OEICs;
  - UK-listed investment trusts;
  - life assurance policies on the sole life of the ISA investor;
  - units in a stakeholder medium-term investment product;

   — shares acquired in the previous 90 days from an all-employee savings-related share option scheme (SAYE).

- A **cash ISA** can include:
   — bank and building society deposit accounts;
   — units or shares in UK-authorised unit trusts and OEICs that are money-market schemes;
   — stakeholder cash deposit products.
- An **innovative finance ISA** involves investing via a peer-to-peer (P2P) lender (P2P lending was discussed in Topic 6).
- A Help-to-Buy ISA (now closed for new applications) was to help those saving for their first UK home by adding a bonus to any savings they make.
- A Lifetime ISA can be used to buy a first home (replacing the Help-to-Buy ISA) or save for later life (see section 9.1.6)

ELIGIBILITY RULES FOR ISAS

- The minimum age for investing in a stocks and shares, innovative finance ISA or Lifetime ISA is 18 years (Lifetime ISAs also have a maximum age of 40); a cash ISA can be opened by anyone aged 16 or over.
- An ISA investor must be generally resident in the UK for tax purposes.
- An ISA can only be held in a single name, ie joint accounts are not permitted.
- Lifetime ISAs have different eligibility rules (see above).

9.1.2 Subscription limits

The purpose of granting tax benefits on investments held within an ISA is to encourage people who might not otherwise have saved funds to do so. To ensure that the tax benefits meet that objective, there are limits on the maximum amount that may be saved each tax year. The limit means that those who already have adequate savings cannot benefit further by switching their savings into ISAs to gain greater tax benefits.

Provided the overall annual subscription limit is not exceeded, an individual investor can choose to invest the full annual amount into a stocks and shares ISA, or a cash ISA or an innovative finance ISA, or split their investment in any proportion they wish.

ADDITIONAL PERMITTED SUBSCRIPTIONS

On death, ISA holdings are designated as a "continuing account of a deceased investor" and remain so until the earlier of the:

- administration of the estate;
- closure of the account; or
- third anniversary of death.

While no further funds can be added, the holding continues to benefit from the tax advantages of an ISA.

An 'additional permitted subscription' (APS) allowance applies when an individual's spouse or civil partner dies. The purpose of the APS is to protect the tax benefits around savings held within an ISA. It allows the surviving spouse/civil partner to make an additional ISA subscription to the value of the deceased's ISA holdings.

The right to make a cash APS applies for three years from the date that the person died, or 180 days after administration of the estate is complete, whichever is later. For stocks and shares, the time limit is simply 180 days after administration of the estate is complete. The additional subscription can be made with the manager who held the deceased's ISA or with another manager who agrees to accept the subscriptions. Its value can either be the value of the deceased's ISA at the date of their death or at the point the ISA ceased to be a continuing account of a deceased investor.

FACTFIND

Details on the ISA subscription limits can be found here:

www.gov.uk/individual-savings-accounts

9.1.3 Withdrawals and transfers

ISA providers have the option to offer flexibility, allowing funds withdrawn from a cash or innovative finance ISA, or the cash element of a stocks and shares ISA, to be replenished during a tax year. However, providers are not obliged to offer this flexibility.

Many ISA providers allow no-notice withdrawals to be made, although there are some fixed-rate cash ISAs that do not permit withdrawals during the fixed-rate period.

Funds may be transferred between different types of ISA without contravening the ISA limits. ISAs can be transferred between providers.

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ISA WITHDRAWALS

John invests £12,000 in a cash ISA on 6 April, when the full annual subscription limit is £20,000. On 1 July of the same year he withdraws £7,000, leaving a balance of £5,000.

If the ISA offers flexibility he could still invest £15,000 in the remainder of the tax year (ie £20,000 – £5,000).

If the ISA does not offer flexibility, then the maximum he could pay in, following the £7,000 withdrawal, would be £8,000 (£20,000 – £12,000).

9.1.4 Tax reliefs

Investors are exempt from income tax and CGT on their ISA investments.

As a comparison, an investment held in a unit trust is potentially liable to CGT on encashment. If the unit trust is held within an ISA there is no liability to CGT.

9.1.5 Help-to-Buy ISA

The Help-to-Buy ISA is a cash ISA that was available from 1 December 2015 until 30 November 2019. It was designed to help those saving for their first UK home by adding a bonus to any savings they make. The scheme was open to those aged 16 or over, and joint purchasers were able to open individual accounts that each earn a bonus payment. Anyone who opened an account by 30 November 2019 will be able to use the funds invested and the bonus payment towards the purchase of a first home by 1 December 2030.

Account holders could make an initial deposit of up to £1,200. Monthly savings of between £1 and £200 can be made until 30 November 2029. Each £200 paid in attracts a bonus payment of £50, subject to the ISA being worth at least £1,600 when funds are withdrawn for home purchase. The minimum bonus size is £400 and the maximum £3,000. The bonus is available on purchases of up to £450,000 in London and £250,000 elsewhere in the UK and is paid when the home purchase is completed.

Savings into a Help-to-Buy ISA form part of the annual ISA allowance, rather than being in addition to it.

9.1.6 Lifetime ISA

A Lifetime ISA was introduced from 6 April 2017, with the aim of encouraging younger people to save for their first home in the UK, to a value of up to £450,000, and/or for their retirement. The main rules are as follows:

- A Lifetime ISA can be opened by those aged between 18 and 40.
- Savings made before the age of 50 attract a bonus of 25 per cent (paid by the government).
- In 2017/18, the bonus was paid annually but since 6 April 2018 it is paid monthly, which enables interest to be earned on the bonus.
- A maximum of £4,000 may be saved per tax year; there is no monthly savings limit.
- The underlying investment choices are the same as those in the cash and stocks and shares ISAs.
- Savings into a Lifetime ISA form part of the annual ISA allowance, rather than being in addition to it.
- Savings can be used to purchase a first home and/or retained to provide benefits in retirement from the age of 60.
- Savings, including the bonus, can also be withdrawn when the accountholder is terminally ill.
- A 25 per cent penalty is applied if funds are withdrawn for reasons other than the purchase of a first home, the holder reaching age 60 or the holder suffering a terminal illness.
- An individual may contribute to both a Help-to-Buy ISA and a Lifetime ISA, but the bonus payment from only one of these ISAs can be used towards the purchase of a first home.

FACTFIND

Lifetime ISA accounts have been available to people under the age of 40 since April 2017. Keep up to date with latest developments by searching GOV.UK. The following document provides some useful further detail:

www.gov.uk/lifetime-isa

9.2 Child Trust Fund

The Child Trust Fund (CTF), a tax-free savings account for children, was introduced in 2005 to encourage savings on behalf of children, and was available to children born on or after 1 September 2002. When Child Trust Funds were introduced, the intention was that the government would make contributions to them; however, government contributions ceased in 2011.

CTFs are no longer available to new savers, although existing CTFs can be retained as a vehicle for family and friends to save for a child. Alternatively, a CTF may be transferred into a Junior ISA (see section 9.3).

A summary of the main characteristics of the Child Trust Fund is as follows.

- At the time the CTF was introduced, each individual CTF began with an initial payment provided by the government in the form of a voucher, sent automatically to the Child Benefit claimant. If the child's family was eligible for the full Child Tax Credit, the initial payment was £500; for others, it was £250.
- The government payment was reduced to £50 for children born on or after 1 August 2010 (or to £100 for those in families eligible for full Child Tax Credit). Government payments were withdrawn altogether on 1 January 2011.
- The parent or carer used the voucher to open a CTF account.
- The account remains in force until the child's 18th birthday, at which point the child has access to the money in the account and can use it for any purpose they wish. There is no access to money in the account before the child's 18th birthday.
- The child's parents remain responsible for the CTF until the child is 16, after which the child can manage their own account.

9.2.1 Types of Child Trust Fund

There are three general types of CTF:

- deposit-type savings accounts, which are bank and building society accounts that offer fixed or variable rates of interest;
- share accounts that can hold a range of investments similar to those available in a stocks and shares ISA;
- stakeholder CTF accounts.

Stakeholder CTF accounts invest in a range of company shares, subject to certain government rules designed to reduce the risk. Originally, from the child's 13th birthday, the money had to be gradually moved to lower-risk assets to protect it from stock market losses closer to the child's 18th birthday. This restriction no longer applies.

The maximum annual charge permitted on a stakeholder CTF is 1.5 per cent. There is no limit on charges on other types of CTF.

9.2.2 Subscription limits and taxation

Parents (and other family members or friends) can make additional investments into a CTF, up to an annual maximum. The subscription year for CTFs is slightly different from that for ISAs, as it runs from the child's birthday to the day preceding their next birthday. As with ISAs, there is no tax on income or capital gains from the CTF.

9.3 Junior ISAs

Junior ISAs (JISAs) became available in November 2011 when the Child Trust Fund (CTF) scheme closed. Children cannot have both a JISA and a CTF, but CTFs can be transferred into JISAs on request. JISAs confer the same tax benefits as an adult ISA. Stocks and shares and cash JISAs are available, and investment can be made into one type or split between each. As with other ISAs and CTFs, there is a maximum annual investment limit.

Where a child is aged under 16, a JISA can only be opened and managed by the child's parent (or another adult with legal responsibility for the child). An eligible child aged 16 or over can open and manage a JISA on their own behalf; if a JISA has already been opened for them, they become responsible for managing it.

Funds cannot be accessed until the child reaches 18; once the child is 18, the account becomes a conventional adult ISA.

FACTFIND

Check the current annual investment limits for CTFs and JISAs at:

www.gov.uk/child-trust-funds

and:

www.gov.uk/junior-individual-savings-accounts

9.4 Venture Capital Trusts and the Enterprise Investment Scheme

Newly established companies, particularly those not listed on a stock exchange, can find it difficult to raise the funds they need to grow. To encourage private investors to provide funds to such companies, the government offers various schemes that incentivise investment through the award of tax benefits. The two main types of scheme are Venture Capital Trusts (VCTs) and the Enterprise Investment Scheme (EIS).

The main difference between the two types of scheme is that a VCT is an investment in its own right, a collective investment, whereas the EIS is a system of tax reliefs that an individual company applies for; if a company is eligible for the EIS an investor in the company can claim the available tax reliefs.

9.4.1 Venture Capital Trusts

A Venture Capital Trust (VCT) is a company whose shares are listed (and can therefore be traded) on the stock exchange; it is run by an investment manager. The VCT normally spreads the monies raised from investors over a range of different companies.

Investment into a VCT is normally viewed as high risk, so income tax reliefs are granted to make the proposition more attractive:

- Income tax relief at up to 30 per cent is given on an investment of up to £200,000 per tax year.
- Any dividends paid by the VCT from the £200,000 permitted maximum investment are tax free.
- Any capital gains are exempt from CGT.
- A VCT must be approved by HMRC and must meet certain conditions to gain approval.

> **FACTFIND**
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> To find out more about VCTS, including the current rules relating to tax relief, go to:
>
> www.gov.uk/guidance/venture-capital-schemes-raise-money-by-offering-tax-reliefs-to-investors#venture-capital-trust-vct

9.4.2 Enterprise Investment Scheme

In a similar way to a VCT, the Enterprise Investment Scheme (EIS) is designed to encourage investment in certain smaller, high risk companies by the provision of tax relief. The main difference is that whereas a VCT is a listed company that undertakes the investment on the behalf of the investor, the EIS involves direct investment in a company that is eligible for the scheme.

As with VCTs, EIS investment is seen as high-risk so tax reliefs are offered:

- Income tax relief at up to 30 per cent is given on an investment of up to £1,000,000 (£2,000,000 if the amount invested in excess of £1,000,000 is made in knowledge-intensive companies) per tax year.
- The CGT on any capital gains that are reinvested is deferred.
- Capital gains from investment in the EIS are exempt from CGT, provided that the EIS shares have been held for at least three years.

As with the VCT there are a number of conditions that must be met for the tax reliefs to be granted.

There is also the Seed Enterprise Investment Scheme (SEIS), which offers even higher tax reliefs than the EIS, as it is targeted at raising funds for small start-up companies.

FACTFIND

Further information is available on the GOV.UK website.

www.gov.uk/guidance/venture-capital-schemes-apply-for-the-enterprise-investment-scheme

www.gov.uk/hmrc-internal-manuals/venture-capital-schemes-manual/vcm35010

THINK AGAIN ...

Now that you have completed this topic, how has your knowledge and understanding improved?

For instance, can you:

- describe the different types of ISA?
- outline the rules relating to subscription limits, withdrawals and transfers?
- describe the key features of the Help-to-Buy and Lifetime ISAs?
- explain the rules relating to Junior ISAs?
- describe VCTs, the EIS and SEIS and the key differences between them?

Go back over any points you don't understand and make notes to help you revise.

Test your knowledge before moving on to the next topic.

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Test your knowledge

Use these questions to assess your learning for Topic 9. Review the text if necessary.

Answers can be found at the end of this book.

1) Stella, aged 24, has invested £4,000 per year into a cash ISA for the past 3 years. In the current tax year, she received an inheritance and invested the full subscription limit into her cash ISA, but now she would like to split the money between her cash ISA and a stocks and shares ISA. Is she able to do this in the current tax year?

2) In what circumstances is an additional permitted subscription (APS), over and above the usual investment limit, allowed in respect of an ISA?

3) Following someone's death, the right to make a cash additional permitted subscription (APS) lasts for the later of 180 days or what length of time from the date of death?

   a) 6 months.

   b) 12 months.

   c) 2 years.

   d) 3 years.

4) In the current tax year, Jane invested £10,000 into a stocks and shares ISA that does not offer a flexible investment facility. Later in the current tax year, she withdrew £1,760. Given an annual ISA investment limit of £20,000, how much would Jane be able to pay into ISAs during the remainder of the current tax year?

   a) £10,000.

   b) £12,240.

   c) Nil.

   d) £20,000.

5) The advantage of holding investments in a stocks and shares ISA, rather than holding collective investments directly, is that the ISA investment is free of what taxes?

6) Existing Help-to-Buy ISA customers can continue saving up to £200 per month until:

a) 30 November 2021.

b) 30 November 2024.

c) 30 November 2026.

d) 30 November 2029.

7) What is the purpose of the Lifetime ISA?

8) An investor can increase their annual ISA investment limit by taking out a Lifetime ISA, a Help-to-Buy ISA and a standard ISA. True or false?

9) Aaron, aged 12, has a Child Trust Fund. His mother wants to open a Junior ISA for him instead, but she is unable to transfer the Child Trust Fund into a Junior ISA and Aaron cannot hold both types of account. True or false?

10) Which type of investment normally represents a higher risk: an investment trust or a venture capital trust?