Chapter Twelve
Tax

It is galling that the government takes another slice on dividends and capital gains after it has already charged additional tax on investing taxed income. But reconcile yourself with the thought that at least you have profits to be taxed.

Tax is always complicated, and huge manuals have been written on how to cope or get the best deal possible to frustrate the efforts of HM Revenue & Customs (HMRC). This chapter represents the merest skimming of the surface and is generalized as these things change continually.

Governments have tried to steer us towards some investment vehicles by tax incentives because they think they would be good for us or for the country. It would be foolish not to take advantage of any extra benefits provided by the tax office, but it would be just as silly to invest purely for the tax break. This is especially so as the management fees for some schemes need careful scrutiny to test whether the deal is still worth it after the professionals have had their share of the cream. So weigh the alternatives and go for the one that is best, judged by your personal criteria, and only go for the savings in tax if the investment would have made sense without them.

Governments are rather good at taking money off us. There is not only tax on getting into shares – called 'stamp duty' – but also on the benefits from most kinds of investment, both on the income and the capital appreciation. Dividends, including scrip issues (see Chapter 11) and bonus shares, count as income and therefore are subject to Income Tax. Most companies pay dividends net of tax.

HMRC publishes some useful booklets on tax, including one on capital gains tax (CGT), available from all tax offices.

Dividends

Dividends on shares are almost invariably paid net of tax and the voucher that comes with the payment notification contains details of a tax credit. People who do not normally pay Income Tax cannot reclaim the tax already paid on the dividend. Those who pay tax at the basic rate need pay no further tax on the income. But people paying tax at the higher rate have to pay at 32.5 per cent of the gross, though the credit detailed in the slip is set off against this. This means that the higher-rate taxpayer will, in effect, pay top rate of tax on the gross dividend paid by the company. This complicated way of handling things means that about a quarter of the net dividend is due in tax for higher-rate payers.

So, for instance, someone owning 400 shares in Quilp & Heep Intercontinental, which pays a 15p dividend, would get a cheque for £60. Since the tax credit is 10 per cent, this represents 90 per cent of the gross dividend, which would have therefore been £66.66 (60/90 × 100). As a result, the tax credit notified with the cheque would be £6.66. Payers on the standard rate of tax are then all square, but payers at the higher rate, obliged to pay 32.5 per cent of the gross, must now calculate 66.66 × 32.5/100, which works out to £21.66. Setting off the £6.66 already paid leaves a liability of £15 to be sent to HMRC.

Scrip issues of shares in lieu of dividend (see Chapter 11) are treated in a pretty similar fashion. There is no additional tax due for people on the standard rate, and those paying the higher rate are assumed to have had a 10 per cent tax credit.

If the company buys back shares, the money received is treated as a dividend – covered by Income Tax, not CGT.

Capital profits

A profit on the sale of shares is liable to tax for profits above the basic tax-free allowance. This is a pretty handsome chunk as far as most small investors are concerned. CGT is a problem only for people dealing in largish amounts or who have really struck it lucky with one of their stocks. In other words, if the profit is so great that CGT is due, you have done so well that a bit for the exchequer seems less painful. Windfall shares received from demutualized building societies or insurance companies are counted as having cost nothing and anything made from their sale is counted as a capital gain – unless they have been put into a tax-sheltered scheme such as a SIPP or ISA.

There is a tapered tax relief, however, so holding shares for a long time will reduce the tax liability. If the shares were bought before April 1998 the price rise can be adjusted for inflation before tax is payable. Dealing costs in buying and selling are allowable against the total gain, and there is an allowance for part-paid shares. Gifts between spouses are tax-free, so the portfolio can be adjusted to benefit from the maximum allowance.

Unquoted shares are a problem since there is no publicly available unequivocal price for dealing. For these deals you will just have to haggle with the local HMRC office.

As is only fair, losses made from selling shares in the same tax year can be set off against the profit. And if any of the companies actually go bust, the shares are reckoned to have been sold at that date for nothing and the capital loss from the purchase price can also be set off against gains.

All this may help with decisions between alternative courses of buying and selling, though once again being guided purely by tax differences is usually a mistake. A good accountant can advise on such things at a relatively low cost.

Employee share schemes

Receiving shares from an employer counts as pay and so is subject to Income Tax. If the employees (and that includes directors) buy the shares at a discount to the market price, the discount portion is the part on which tax is paid.

Under approved profit-sharing schemes the company can allocate tax-free shares to workers, though as you would expect, there is a raft of rules about the details. Share option schemes that meet all the chancellor's requirements have few advantages.

Tax incentives to risk

The government wants new ideas to be financed, high-technology to get started, and innovations to be given a chance. Investment institutions such as venture capitalists will not touch them, so the tax incentives are directed at private investors. These are risky ventures and though rewards can be high for a success, the chance of failure is also pretty high. Even with the tax come-ons this is an area for people with a steady base of safe investment who also have a few hundred thousand to gamble with.

Venture capital trusts

These are really just a collective version of the Enterprise Investment Scheme it replaced. The tax breaks are similar but the investment is into a quoted financial vehicle, which in turn puts the cash into a range of entrepreneurial businesses, so the risk is reduced, as with investment and unit trusts, by spreading the money over a number of ventures.

ISAs

Individual savings accounts are part of the government's aim to persuade us to save more of our income by providing tax incentives. The amounts which can be invested in each tax year, of which all is invested in shares – including AIM shares – and a proportion may remain in cash, changes with the Budget announcements. A good stockbroker has the current rates.

SIPPs

Self-Invested Personal Pensions (SIPPs) offer the freedom to choose and manage investments (from the list approved by the Revenue) and unlike traditional pensions in which the provider owns the investments, the prospective pensioner owns the assets. They therefore offer flexibility in choosing investments and taking retirement benefits so long as they are arranged by a suitable provider to pass stringent criteria for tax. SIPPs, in common with personal pension schemes, are tax 'wrappers', allowing tax rebates on contributions in exchange for limits on accessibility.

Among the assets not subject to a tax charge are unlisted shares, shares listed on a recognized exchange, futures and options traded on recognized futures exchanges, authorized UK unit trusts, OEICs and other UCITS (see Glossary), unauthorized unit trusts that do not invest in residential property, investment trusts subject to FCA regulation.

Contributions to SIPPs are treated as other types of personal pension on limits. Higher rate taxpayers claim a tax refund through the tax return. Employer contributions are usually allowable against corporation or income tax. A fund value at retirement above the lifetime allowance (the amount fluctuates with Budgets), is taxed at 55 per cent.

A SIPP holder reaching early retirement age of 55 may take up to a quarter of the fund as tax-free lump sum, and the rest must either be moved into generating an income from 'drawdown' (where it remains invested) or used to buy an annuity. The drawdown income is to be in line with what the Government Actuary's Department reckons an annuity would generate. This is reviewed every three years until age 75 and then annually. This limit does not apply to plan holders who can show that they have arrangements in place to provide a minimum guaranteed income from other sources and who are no longer contributing to a pension. Pension income is taxed as income at the owner's highest marginal rate.

Tax rates

Chancellors have to be seen to be earning their keep, so each year's budget produces some tinkering with tax rates, allowances and incentives. Recently there has been a spate of last year's incentives suddenly being relabelled 'vicious avoidance loopholes' that need to be withdrawn. Sometimes impending elections or other political exigencies produce a need for other public reactions as well. As a result, the picture continuously shifts in detail. That is why this section has given a general picture and the overall policies but carefully omitted numbers. To get the latest levels of tax rates, allowances and benefits, telephone any of the 10 largest accountancy firms, all of which will almost certainly have a free leaflet summarizing the current position.

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Glossary

acid test: a check in the company's balance sheet to see if it has enough liquid assets to meet its current debts.

Alternative Investment Market: the part of the London Stock Exchange for small companies or ones too young to meet the requirements for full quotation; often abbreviated to Aim.

assets: in a company's balance sheet these are the things it owns or are owed to it; net assets in the balance sheet are defined as capital plus reserves, or total assets minus current liabilities, and deducting the long-term creditors.

authorized share capital: every company has a memorandum and articles of association and these show how many shares it may issue. It is not compelled to issue all of them and many companies keep some in reserve for rights issues, employee incentives and the like (*see also* issued share capital).

bear market: a time of generally falling share prices.

bid: the price at which the managers of unit trusts will buy back the units from investors, compared with the offer at which they sell units; also loosely used for the offer in a takeover.

blue chip: a top-quality company and its shares, derived from the top-value gaming chips used in casinos and poker.

bond: an IOU issued by a borrower to the lender to acknowledge the debt; it normally carries a fixed rate of interest and can be traded (eg gilts, debentures).

bonus issue: another name for a scrip issue; the distribution of shares to existing holders at no cost to them.

broker: *see* stockbroker.

bull market: a period of rising share prices.

call option: the right to buy a share at a set price within the period of the agreement.

capitalization issue: *see* scrip issue.

common stock: US name for ordinary shares.