Office of
Tax Simplification

Savings income:
routes to simplification

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Contents

Foreword		1
Executive summary		2
Chapter 1	Savings and dividend income: taxation, rates and allowances	9
Chapter 2	Individual Savings Accounts (ISAs)	27
Chapter 3	Pension income	32
Chapter 4	Life insurance bond withdrawals	38
Chapter 5	Collective investment schemes	45
Annex A	Stakeholder list	47

Foreword

This is the first broad review of its type into the application of the tax system to savings and investment income.

The UK savings tax system works well for most taxpayers, who do not have to consider whether they have to pay income tax on their savings at all. This is because, since 2016, savings income up to £1,000 has been covered by the personal savings allowance and because savers can contribute £20,000 a year to their ISAs on which income is not taxed.

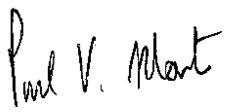
However, many taxpayers continue to worry about the tax treatment of their savings income even when they do not in fact have anything further to pay, and there are also many specific complexities which taxpayers find difficult and confusing.

In this review, the OTS has found that –

- The tax complexity in savings and investment income is mainly caused by the interactions between the many reliefs and allowances;
- Any solution will need to take a comprehensive view to ensure that these interactions are fully scoped and that the intended benefits for taxpayers from those reliefs and allowances are preserved;
- There are additional opportunities to improve the taxpayer experience through guidance and further communication.

The OTS would like to thank the members of the team who have worked on this review, Eileen Rafferty and Andy Richens, under the guidance of David Halsey, the OTS Head of Office. We are also particularly grateful to HMT and HMRC colleagues and many others who have willingly given their ideas, challenge and support.

Angela Knight CBE



Paul Morton

Executive summary

The Office of Tax Simplification (OTS) is the independent adviser to government on simplifying the UK tax system. The work of the OTS is rooted in improving the experience of all who interact with the tax system. The OTS aims to reduce the administrative burden - which is what people actually encounter in practice - as well as simplifying the rules. These are often of equal importance to taxpayers and HMRC.

This paper explores the taxation of people's savings income, and identifies areas that might be simplified. The paper looks at income from savings held in cash or in stocks and shares. People may choose to invest in other classes of asset (property for example) - these are not the subject of this paper.

The taxation of income from savings and investments potentially impacts a substantial number of UK citizens, as approximately 65% of UK adults save some of their income, and many have a private pension (78% of employees, 17% of the self-employed).[1] Nevertheless, it is estimated that around half of the UK population are not saving enough for their retirement,[2] while at the average rate of savings, it would take 18 years to save a deposit on a first home, or 17 years in a cash ISA.[3] [4]

There are clear benefits both to individuals and to society as a whole when people have sufficient savings, and so the UK tax regime offers a range of tax reliefs to encourage people to put money aside for their future needs. These reliefs work well for most taxpayers, but aspects of the regime, including the interaction of various reliefs and allowances, are complex and can produce anomalous outcomes.

This paper considers:

1. The taxation of interest and interest-like payments, which are affected by the starting rate for savings (SRS) and personal savings allowance (PSA)

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1 Source: For workplace pensions – Office of National Statistics June 2017 report https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/618843/workplace-pension-participation-and-saving-trends-2006-2016.pdf For private pensions: the Money Charity. http://themoneycharity.org.uk/media/July-2015-Money-Statistics-summary.pdf http://themoneycharity.org.uk/households-saving-ratio-lower-time-since-credit-crunch/

2 Source: The Pensions Advisory Service. https://www.pensionsadvisoryservice.org.uk/news/fewer-than-half-of-people-in-the-uk-are-saving-enough-for-retirement

3 Source: The Money Charity, as above. See this site also for a comparison of savings rates since 1956. https://tradingeconomics.com/united-kingdom/personal-savings

4 There is evidence that the Help to Buy ISA speeds up the process of saving for a first home, particularly in cases where values are below the UK average.

https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/702671/Help_to_Buy_ISA_scheme_quarterly_statistics_-_December_2015_to_30_Decemb....pdf

2. The taxation of dividend income and the dividend allowance

3. The various kinds of ISAs that are available

4. Pension income

5. Life insurance bond withdrawals

6. Unit and investment trusts, Open Ended Investment Companies and unregulated funds

Core observations

i) 95% of people pay no tax on savings income (in this paper, savings income includes interest, dividends, income from pensions and from investment bonds and funds).

The personal savings allowance means the first £1,000 of savings income (for basic rate taxpayers) is taxed at nil %.

For individuals with very low non-savings income (such as earnings, pensions and rents), an additional nil % tax rate applies to savings income up to £5,000.

£20,000 can be invested annually in an ISA with no tax payable on interest or other income from that investment. Married people or civil partners may receive the benefit of their partner's ISAs on death with no tax charge.

Income from shareholdings held inside an ISA is exempt. If people hold shares outside an ISA, dividends of less than £2,000 are not taxed.

The combined effect of these provisions is that 95% of people have no tax to pay on savings income.[5] This significantly simplifies the taxation of savings income in the UK.

ii) There is greater awareness of ISAs compared with the savings and dividend allowances

The OTS understands that savers are often unaware of the savings and dividend allowances, while many people know that money put into ISAs does not get taxed. This different level of knowledge may lead to sub-optimal decisions.

Illustrative case study 1: Gary – cash savings

Gary has had a cash ISA for a number of years, and is looking at investing £1,500 this year. He has seen a good rate of interest on an ordinary deposit account, but is worried that this would be taxed, so that he would receive less income, and that he would also have to engage with the tax system.

An interest return of less than the personal savings allowance (£1,000 for basic rate taxpayers) would mean no tax would be payable this tax year on the level of investment being considered.

5 https://www.gov.uk/government/news/budget-2015-some-of-the-things-weve-announced

So Gary does not need to worry about tax on his £1,500. In fact, he could put considerably more than this into his savings and still pay no tax.[6] He could additionally invest up to £20,000 in an ISA and still would pay no tax.

iii) The tax treatment of pension fund withdrawals is not well understood

The recently-introduced pension freedoms allow people over 55 or in poor health to make withdrawals from pension pots, and significant numbers of people have cashed small pension pots. However, there is evidence that people do not always understand the implications of their withdrawals.[7]

iv) There is scope for more focus on guidance and awareness

Studies show that financial literacy in the UK is relatively low, below the OECD average.[8] Even comparatively clear HMRC guidance in this area[9] will be difficult to follow for the very significant section of the population whose financial capability is not high (in this context the OTS notes that UK individuals who self-assess their knowledge as high fare no better than average when measured against people from higher-performing countries on objective tests).[10] The OTS has started a project to take a strategic look at the approach to taxpayer guidance, in collaboration with work HMRC is itself doing to overhaul its 290 manuals.

The government's Financial Capability Strategy aims to improve financial capacity over time and is building evidence on what works in this context.[11] There is scope to significantly improve guidance and education on the taxation of savings to help citizens make more informed choices, and the OTS strongly urges HMRC to focus on improving this guidance and making it easier to understand, using learning from the Financial Capability Unit where relevant (paragraphs 1.70 – 1.72).

Recommendations for further work

Streamlining the interaction of income tax rates and allowances

The starting rate for savings (SRS), personal savings allowance (PSA), dividend allowance and other allowances and features of the tax system mean that most people pay no tax on their savings, but the interactions between the rates and allowances is sufficiently complex at the margins that HMRC's self-assessment

6 Savings returns vary considerably. At rates varying between 0.75% and 1.6% (a range obtained from standard money comparison websites in May 2018) one would need between £133,333 and £62,500 on deposit to obtain this return. Some retail banks offer rates of 0.2% or lower: at this rate, one would need £500,000 to get a return of £1,000.

7 https://www.ft.com/content/46ef41b4-fba3-11e7-a492-2c9be7f3120a https://www.fca.org.uk/publication/research/financial-lives-survey-2017.pdf

8 http://www.oecd.org/daf/fin/financial-education/g20-oecd-infe-report-adult-financial-literacy-in-g20-countries.htm

The Money Advice Service: Financial Capability in the UK, 2015; https://prismic-io.s3.amazonaws.com/fincap-two%2Fd08746d1-e667-4c9e-84ad-8539ce5c62e0_mas_fincap_uk_survey_2015_aw.pdf

UKCES: Employer Skills Survey 2015 https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/525449/UKC004_Summary_Report__May_.pdf

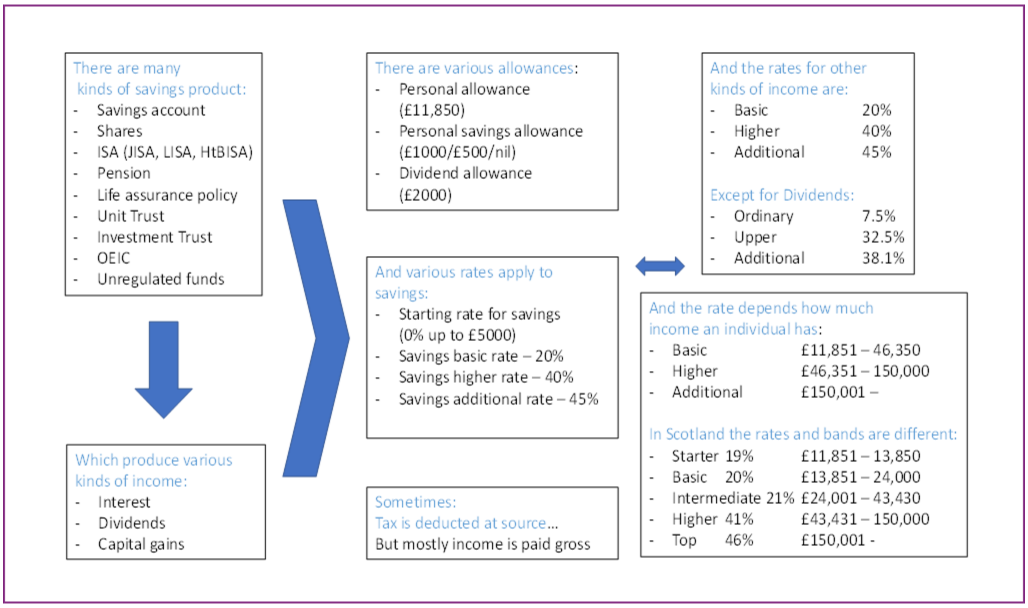
9 https://www.gov.uk/apply-tax-free-interest-on-savings

10 OECD report on adult financial literacy, pages 20-23.

11 https://www.fincap.org.uk/

computer software has sometimes failed to get it right. It is proving to be very difficult to create an algorithm that calculates the tax correctly in all circumstances and HMRC does not expect to bring the complete calculation online until 2018-19. Chart 1.A below illustrates this complexity.

Chart 1.A: Chart showing current savings reliefs and allowances 2018/19



The OTS considers that it would be useful to open up a discussion about the reasons for the number of rates and allowances (which will be added to by some of the new differences resulting from devolution) and the impacts of possible alternative approaches in this area.

The following potential approaches are explored in Chapter 1 (Savings and dividend income)

- Specify the order in which allowances are to be deducted, for example in line with the order in which the components of income are taxed (paragraph 1.58)

- Make the PSA and the dividend allowances true allowances or exemptions (as their names suggest) rather than a nil rate of tax. This would simplify the calculation. Income falling within the allowance would not need to be reported and would not count towards the individual's total income (for example for the purpose of the higher and additional rates) (paragraph 1.60)

- Exempt savings interest completely, either for basic rate payers only, or for individuals with total income below a certain threshold, or for individuals over pension age (paragraph 1.69)

- Amalgamate the starting rate with the PSA, resulting in a combined allowance of £6,000 for basic rate taxpayers, or £5,500 for higher rate taxpayers. This would reduce the complexity arising from having two separate allowances and would remove the condition attached to the SRS, which only applies in circumstances in which non-savings income is below a certain amount (paragraph 1.69)

Introduce a personal tax roadmap (to incorporate plans for the taxation of savings)

Although savings taxation currently works well for most taxpayers, there are opportunities to improve the position further, especially as a minority experience real challenges at present. Many of the issues have arisen because of a series of changes, each working well enough taken by itself but which together create significant complexity that is not easily resolved.

The OTS considers that further work on options to consolidate some of these rates and allowances should be undertaken. To approach this area in a strategic way, a personal tax roadmap, along similar lines to the current business and corporate tax roadmaps, could set the future direction for income tax, including for savings income, and outline the stages needed to get there. People need a level of certainty in order to plan their financial futures and this part of the personal tax system has seen a significant number of changes in recent years: a roadmap could help stabilise the position as well as increasing transparency (paragraphs 1.56 and 1.57).

Increase flexibility on ISAs

The general principles of how ISAs work are well understood, although some of the finer detail is confusing (such as which combinations of ISA types may be taken out). The OTS considers further changes can be made to simplify ISA rules for investors: for example, allowing partial transfers of money invested in year (in line with transfers from previous years' ISAs), or removing the requirement that an investor may only take out one ISA of each type per year, subject to the overall annual limit (paragraphs 2.14 to 2.17).

Revisit the rules on early withdrawals from the lifetime ISA

The long-term nature of the lifetime ISA and the charge for early withdrawal mean that savers are potentially tied into the product for decades. A lifetime ISA can contain cash or stocks and shares, or a mixture of both, but cash may not be the best investment option for any substantial sum over such a long period and stocks and shares are a high risk option for someone saving for their first home.

Major financial institutions have told the OTS that they have decided it would be inappropriate to offer cash LISAs to unadvised retail investors, who may not be able to form an assessment of best value at the time of investment and will be penalised if they change their mind at a later stage. The charge for withdrawals (other than for defined purposes) is a significant design feature that adds to the challenge on giving advice. This concern was noted also by the Association of Accounting Technicians in their recent paper on ISAs.[12]

The OTS understands that the number of authorised ISA managers is still relatively small. This seems an opportunity wasted and it is suggested that further consideration should be given to how best to ensure that the LISA rules work effectively for unadvised savers. Indeed, the OTS would like to see a full review of the current ISA landscape, to simplify the regime (paragraphs 2.18 to 2.23).

12 https://www.aat.org.uk/prod/s3fs-public/assets/AAT-ISA-Working-Group-Time-change-review-ISA-regime.pdf

Digital Identity

The Open Banking Project will enable customers to allow third parties access to their financial accounts to facilitate price comparisons and money management.[13] Financial providers have suggested that a digital ID for customers would simplify the process. One way of addressing this may be to require the customer's national insurance number whenever a product is taken out (already required for ISAs) – which may also feed in to HMRC's digital agenda. More effective use of existing information could also facilitate the simplifications in ISA rules discussed above (paragraph 2.29).

Review guidance relating to pension withdrawals, and the use of the emergency tax code for lump sum withdrawals from personal pensions

On pension income, particular difficulties arise for taxpayers concerning the treatment of lump sum withdrawals from personal pensions. These are an increasing feature of the pensions landscape. In addition, people who deferred taking the state pension before April 2016 have an option to receive a lump sum payment of deferred income: gov.uk does not explain the special tax treatment of these payments and this cases much confusion.

More could be done to help people understand the tax implications of withdrawals from pension funds and the actions they may need to take. The OTS would like to explore this further with HMRC, in addition to working to identify options other than initial tax deduction using emergency tax codes on personal pension lump sums, which generally results in the deduction of too much tax when the payment is made (paragraphs 3.11 to 3.17 and 3.24-3.32).

Conclusion

This paper sets out both the benefits most taxpayers receive from the current tax rules on savings income and evidence of the significant complexity that occurs in some cases. A range of specific suggestions are made for further work.

The OTS considers it important not to make piecemeal changes, which risk adding further layers of complexity.

For example, the number of rates and allowances for personal savings and dividends is a significant cause of complexity: cutting one or more of the reliefs would be one way to simplify matters, but it would be important to ensure that there are no unforeseen negative consequences.

At the moment, it is not easy for a taxpayer (or the OTS) to understand what the plans are for digital tax accounts and how these interact with tax return processes. Official guidance is good in parts but has notable gaps.

It is against this background that the OTS suggests a roadmap or plan for changes to the personal tax system, to ensure that future changes may be made in a transparent and planned way over time.

13 https://www.openbanking.org.uk/home/what-is-open-banking/

In summary: core observations

i) 95% of people pay no tax on savings income. This significantly simplifies the taxation of savings income in the UK, but areas of complexity and confusion remain.

ii) There is greater awareness of ISAs compared with the savings and dividend allowances. This different level of knowledge may confuse people making decisions about where to save their money.

iii) The tax treatment of pension fund withdrawals is not well understood.

iv) There is scope for more focus on guidance and awareness in this aspect of the tax system.

Recommendations for further work

1 Review the savings rates and allowances and the impacts of possible alternative approaches. (Paragraphs 1.58 to 1.69)

2 Introduce a personal tax roadmap, incorporating a plan for consolidation of the savings income rates and allowances and the stages needed to get there. (Paragraphs 1.56 and 1.57)

3 Improve guidance on the taxation of savings income, using learning from Financial Capability Unit where relevant. (Paragraphs 1.70 to 1.72)

4 Consider whether trusts and personal representatives should be entitled to the Personal Savings Allowance. (Paragraph 1.73)

5 Consider further ISA flexibility, for example allowing partial transfers of money in-year, to further streamline and simplify the rules. (Paragraphs 2.14 to 2.17)

6 Revisit the rules on early withdrawals from the lifetime ISA. (Paragraphs 2.18 to 2.23)

7 Consider options for a consistent digital identity, that might be used for all financial products and facilitate the provision of new and innovative offerings as well as simplifying tax assessment. (Paragraph 2.29)

8 Review guidance relating to pension withdrawals, and the use of the emergency tax code for personal pension lump sum withdrawals. (Paragraphs 3.11 to 3.17 and 3.24 to 3.32)

9 Review rules on partial redemption of life insurance bonds once the new system has bedded down. (Paragraph 4.36)

Chapter 1

Savings and dividend income: taxation, rates and allowances

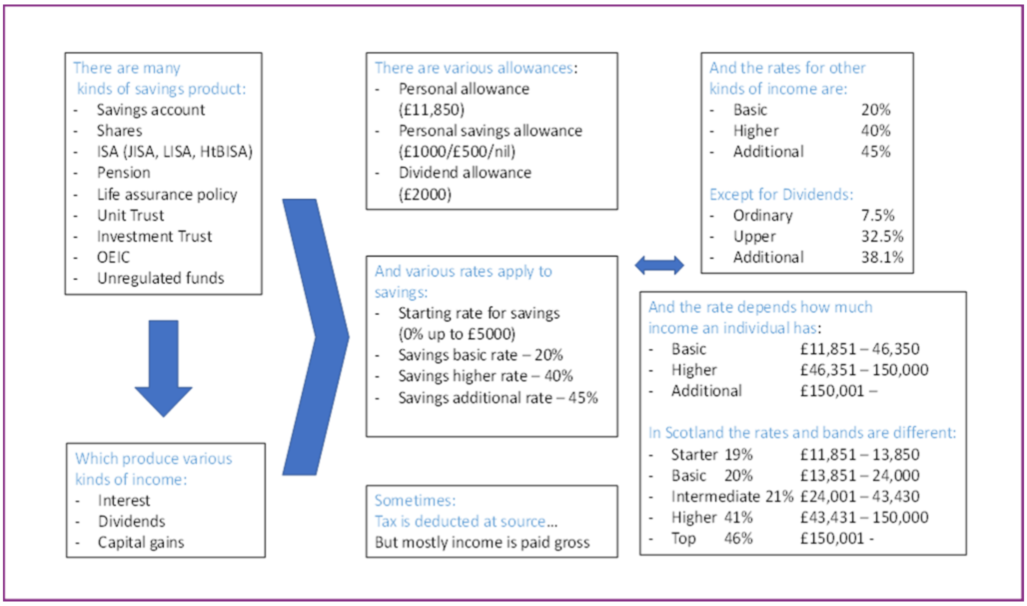
1.1 The UK savings tax system means that most taxpayers do not pay tax on their savings and do not have to report savings income to HMRC. This simplifies tax for most savers and is welcome. However, the calculation of tax on savings income is not always straightforward, and at the margins it is sufficiently complex that HMRC's self-assessment computer software has sometimes failed to get it right. It is proving to be very difficult to create an algorithm that calculates the tax correctly in all circumstances.

1.2 This chapter sets out the core calculation issues for both savings and dividend income and shows how these arise from a series of incremental additions to the regime made over a number of years. The chapter then explores options to address the complexity.

1.3 In considering this area, it is important to look at the taxation of all the core sources of savings or investment income in conjunction with each other.

1.4 Although in many cases there is no liability, the cumulative impact of the various reliefs and allowances adds significant complexity for cases near relevant borderlines and there is considerable scope to simplify the rules. Chart 1.A summarises the position.

Chart 1.A: Chart showing current savings reliefs and allowances 2018/19



Source: OTS

Definition of 'savings income' for income tax purposes

1.5 Tax law defines interest and some other types of income as savings income.

1.6 Income under these headings will be subject to the starting rate for savings, the savings nil-rate, basic, higher and additional savings rates of income tax (see below). Other items of income that may be thought of as arising from savings, for example company dividends or pension income, are subject to different tax treatment, and are discussed separately.

1.7 There are a number of exemptions[1] from income tax for savings income. In particular, some interest received from National Savings Certificates and all interest from investments held in an ISA (discussed in Chapter 2) are exempt from income tax.

Savings income

Tax law defines the following as savings income:

Interest

Interest is compensation for the use by one person of money belonging to another. Common examples are bank and building society interest, interest on gilt-edged securities issued by UK government, and other securities issued by governments and companies, interest on private loans, on delayed payments and refunds and on offshore accounts and investments. Additionally, treatment as interest is extended to:

- any distributions by building societies
- interest distributions by open-ended investment companies
- interest distributions by authorised unit trusts
- offshore fund distributions
- industrial and provident society payments
- funding bonds – a form of security issued by a public or corporate body in respect of a liability to pay interest. The bond value is treated as the interest payment.
- Financial Services Compensation Scheme payments representing interest
- Discounts – when a reward for lending, not a reduction in retail pricing

Other savings income

- Life annuity payments
- Profits from deeply discounted securities - a security where the amount payable on maturity will exceed 0.5% of the issue price per year, up to a maximum of 30 years
- Accrued income profits - public body loan securities which are transferred before the cut-off date for payment of interest
- Gains from life insurance contracts

1 Set out in Part 6 ITTOIA 2005

Taxation of savings income

1.8 To calculate income tax on savings income, it is necessary first to place the components of taxable income in a specified order within a person's total taxable income. Income other than savings or dividends (non-savings income) is taxed first, savings income is next, and dividends[2] are treated as the highest part of total income.

1.9 Savings income can then be subject to a starting rate for savings (nil %),[3] the personal savings allowance - a further savings nil rate,[4] a savings basic rate, a savings higher rate and a savings additional rate. The examples below provide a demonstration of how the rates work. The dividend rates are set out later in the chapter.

1.10 The starting rate for savings can apply only where taxable non-savings income (effectively earnings, pensions or rental income), is less than the starting rate limit (currently £5,000).[5] In such a case an amount of savings income up to the difference between the taxable non-savings income and £5,000 will be charged at the nil % starting rate for savings (So, if you have taxable non-savings income of £3,000 and savings income of £2,500, £2,000 of the savings income will be taxed at the nil rate). Where the non-savings component exceeds £5,000, then the starting rate for savings cannot apply.

1.11 Additionally, the personal savings allowance (PSA) was introduced by FA 2016.[6] The PSA is more accurately described as a savings nil rate, since the amount of savings income covered by the PSA will still form part of the individual's total income (for example, for the purposes of the higher/additional rates, or transferring part of the personal allowance to a spouse/civil partner). The same principle applies to the starting rate for savings described in the paragraph above.

1.12 The PSA is only available to an individual, so does not apply to trustees or personal representatives. Where an individual has

- no income chargeable at the higher rate, the PSA is £1,000
- income chargeable at the higher rate but not the additional rate, the PSA is £500
- any income is charged at the additional rate, the PSA is nil

1.13 The basic calculation for an individual with a small amount of non-savings income is perhaps best illustrated by an example:

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2 S16 ITA 2007

3 S7 ITA 2007

4 S12A ITA 2007

5 Taxable non-savings income is the amount of non-savings income remaining after deductions and personal allowances are taken into account.

6 S12A, s12B ITA 2007

Table 1.A: Example 1 2018/19

In this example, an individual has £15,000 non-savings income and £3,000 savings income.

2018/19	Non-savings income	Tax	Savings income	Tax
Pension	15,000			
Interest			3,000	
Less personal allowance	(11,850)			
Balance	3,150		3,000	
Non-savings income £3,150 @ 20%	3,150	630		
Starting rate for savings £5,000 – 3,150 =£1,850 @ 0%			1,850	0
PSA £1,000 @ 0%			1,000	0
Savings income £150 @ savings basic rate 20%			150	30
Total tax due = £660		630		30

Source: OTS

1.14 The position is further complicated by the fact that the savings and dividend rates are not devolved, while the main rates are. The Scottish Parliament sets rates and thresholds for non-savings and non-dividend income only. And from 6 April 2019, the Welsh Government will set rates, but not thresholds, for non-savings and non-dividend income only. The impact of this different treatment is discussed under 'observations' below.

Deduction of tax at source

1.15 The deduction of tax at source from interest and similar income has been a longstanding feature of the tax system: deduction at source means that the saver receives their interest payment net of basic rate tax. Until April 2016, two separate schemes required deduction of tax at source:

- The tax deduction scheme for interest (TDSI),[7] and
- Deduction of income tax from 'yearly' interest and other types of income.[8]

1.16 Under TDSI, deposit takers (most commonly banks) and building societies were required to deduct income tax at the basic rate before making payments. The introduction of the PSA in April 2016 meant that 95% of individuals with savings have no liability to income tax on their savings income. TDSI would then have created large numbers of repayment claims, so it was abolished from 6 April 2016. For PAYE taxpayers, bank and building society income has been included in tax codes automatically since 2017 so that any taxpayers who need to pay tax on savings income (for

7 Chapter 2 Part 15 ITA 2007

8 Section 874 and Chapter 6 of Part 15 of ITA 2007

example because their income falls above the allowances) do not need to make additional declarations.

1.17 Separately from TDSI, there is a continuing general obligation on companies and certain other types of entity to deduct tax at source when they make payments of 'yearly' interest. The obligation also applies to any person paying yearly interest to a recipient outside the UK. The definition of yearly interest is found in case law: broadly it means amounts payable on an obligation lasting, or intended to last, for more than one year.

1.18 There are a number of exceptions from this obligation, in particular, it does not apply to interest paid by banks and building societies in the normal course of their business. This means that there is no obligation on banks and building societies to deduct tax from, for instance, interest paid on savings or current account balances (to which TDSI is likely to have applied until April 2016). But the exception does not extend to interest paid as part of a compensation payment, for example for mis-selling. A further exception applies to gilt-edged securities, where payments are made gross, unless the holder of the security makes an application for basic rate tax to be deducted.[9]

1.19 There is no mechanism to apply for gross payment of yearly interest in cases where the recipient does not expect to be liable to income tax.

1.20 Payers of some other forms of income not within the savings income definition, such as annual payments[10] (including some reward payments by banks and building societies) are required to deduct basic rate tax in the same way.

Allocation of allowances

1.21 Calculations of tax across the different rate bands and allowances, together with the dividend allowance and rates discussed below, are not straightforward. A tax software provider confirmed the HMRC self-assessment software was producing incorrect results for 2016/17 in a number of scenarios. Again, this is best illustrated by examples:

9 Chapter 5 of Part 15 ITA 2007

10 Annual payments are certain kinds of payment which arise under a legal obligation lasting more than one year, representing income rather than capital in the hands of the recipient

Table 1.B: Example 2 2016/17

In this example, an individual receives 11,000 savings income and 11,000 dividend income

2016/17	Savings income	Tax	Dividends	Tax
Savings income	11,000			
Dividends			11,000	
Less personal allowance	(11,000)		-	
	-		11,000	
Dividends £5,000 @ 0%			5,000	0
Dividends £6,000 @ 7.5%			6,000	450
Total tax due per HMRC software				450
However, the most advantageous allocation of allowances is as follows:				
Savings income	11,000			
Dividends			11,000	
Less personal allowance	(5,000)		(6,000)	
	6,000		5,000	
Starting rate for savings £5,000 @ 0%	5,000	0		
Savings nil-rate £1,000 @ 0%	1,000	0		
Dividends £5,000 @ 0%			5,000	0
Total tax due				Nil

Source: OTS

1.22 Although it may appear the reason for the error is the interaction of the starting rate for savings and the savings allowance, the error actually arose from a sub-optimal **allocation of the personal allowance**. While the components of income are assessed in a defined order of priority as explained above, the allocation of personal allowances (and reliefs available against general income, such as sideways loss relief) should be made in the way which will result in the greatest reduction in the liability to tax.[11]

1.23 As discussed below, dividends formerly carried a non-payable tax credit which effectively offset the income tax payable on them, so allocation of the personal allowance against dividends would not have resulted in any tax saving. Dividends no longer carry a tax credit, and the ability to allocate the personal allowance against dividend income in preference to other income sources to reduce the tax payable was not accounted for in the HMRC self-assessment calculations.

11 S25(2) ITA 2007

1.24 To further demonstrate that the above error is not necessarily a savings income issue, the following example has no savings interest income at all:

Table 1.C: Example 3 2016/17: no savings interest income

2016/17	Earnings	Tax	Dividends	Tax
Earnings	38,000			
Dividends			10,000	
Less personal allowance	(11,000)		-	
	27,000		10,000	
Basic rate £27,000 @ 20%	27,000	5,400		
Dividends £5,000 @ 0%			5,000	0
Dividends £5,000 @ 32.5%			5,000	1,625
Total tax due per HMRC software = £7,025		5,400		1,625
However, the most advantageous allocation of allowances gives:				
Earnings	38,000			
Dividends			10,000	
Less personal allowance	(6,000)		(5,000)	
	32,000		5,000	
Basic rate £32,000 @ 20%	32,000	6,400		
Dividends £5,000 @ 0%			5,000	0
Total tax due = £6,400		6,400		

Source: OTS

1.25 In cases like these, taxpayers were asked to file a paper return by the normal online filing date of 31 January to secure the most advantageous allocation of allowances. The OTS understands that while corrections were made to the calculation software for 2017/18, further errors have resulted.

1.26 HMRC guidance on this matter is not clear and it would be difficult for a non-expert taxpayer to get the calculation right, as the following illustrative case study shows:

Illustrative case study 2: Terry – allocation of tax rates

In 2016/17, Terry had pension income of £7,000, savings interest of £3,000 and dividends of £9,000. Terry has attempted to calculate whether any tax is due, but can find no examples on gov.uk covering this scenario, and is confused by the Tax Return Notes (SA150) which state on page TRG12 that the savings allowance must be reduced by any personal allowance un-used against non-savings and non-dividend income.[12]

12 Step 4, page TRG 12: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/615549/SA150-2017.pdf

1.27 That would imply the following calculation for Terry:

Table 1.D: Table showing tax calculation for Terry 2016/17

	Pension	Savings	Dividends
Pension	7,000		
Savings		3,000	
Dividends			9,000
Less personal allowance	(7,000)	(3,000)	(1,000)
Taxable	0	0	8,000
Tax: £5,000 @ 0%			0
£3,000 @ 7.5%			225

Source: *Based on a submission to LITRG from an individual on 15 April 2017*

1.28 This would not be the most advantageous calculation. The actual liability is potentially nil, as follows:

Table 1.E: Table showing revised calculation for Terry 2016/17

	Pension	Savings	Dividends
Pension	7,000		
Savings		3,000	
Dividends			9,000
Less personal allowance	(7,000)		(4,000)
Taxable	0	3,000	5,000
Tax: starting rate £3,000 @ 0%		0	
Dividend: £5,000 @ 0%			0

Source: *Based on a submission to LITRG from an individual on 15 April 2017*

1.29 A further example of systems failing to cope with the complexities following the introduction of these allowances relates to top slicing relief, is explored in chapter 4 (Life insurance bond withdrawals) below.

1.30 An additional complication arises for Scottish and Welsh taxpayers. As explained above, the savings and dividend rates and allowances are not devolved, leading to an additional step in the calculation. First, the rates applying to UK resident individuals who are neither a Scottish nor a Welsh taxpayer are used to decide what level of PSA is due: one must then go back and apply the relevant Scottish or Welsh rates. The OTS has been unable to find guidance on this matter on official government websites.

1.31 Given the complexities of the multiple rates and allowances set out above, tax charities report a relatively small proportion of savings queries (in one representative organisation in the period 1 April 2017 to 31 August 2017, there were 517 issues raised on the starting rate, compared to 3,185 on pension income). The rates have the effect that many individuals are kept outside of self-assessment (95% of individuals with savings now have no liability to tax on this income[13]), while some individuals may not even be aware of its operation.

Deduction of tax on interest and other payments

1.32 A major bank provided details of the different types of income that customers can receive on a savings or a current account, each having a different tax treatment. This is complex for the customer to understand. A summary of the position is shown in Table 1.F:

Table 1.F: Table showing tax treatment of interest and other payments

Income Type	Paid by bank to individual customer	Within PSA	Reportable by banks to HMRC
Deposit interest	Gross	Yes	Yes
ISA interest	Tax free	No	Yes
Compensation interest	Net	Yes	Yes
Cashback	Tax free	No	No
Reward payment[14]	Net	No	No

Source: OTS

1.33 A single payment can have two components with different tax treatments, for example a refund of overpaid interest plus compensation interest. Compensation interest paid to individuals falls within the definition of yearly interest (paid net of basic rate tax), while refunds of overpaid amounts of interest are not taxable (as they are not interest). Cashbacks and discounts received by ordinary retail customers are outside the scope of income tax and capital gains tax.[15]

1.34 The introduction of the PSA and the end of TDSI added some complexity to the collection of tax on savings and related income. The government consulted[16] on the withholding rules as they applied to compensation interest and a range of other payments, and published their response in 2015. The consultation document raised six potential options for change:

1 Retain the current rules for deduction of tax from non-TDSI interest

2 Remove the obligation to deduct income tax from all non-TDSI interest

3 Remove the obligation to deduct income tax from non-TDSI interest paid to individuals only

13 Number of individuals affected quoted in Tax Information Impact Note: https://www.gov.uk/government/publications/income-tax-personal-savings-allowance-update/income-tax-personal-savings-allowance-update

14 This rule applies to reward payments that are annual payments – not all reward payments are categorised as annual paments.

15 Statement of practice 4/97: https://www.gov.uk/government/publications/statement-of-practice-4-1997/statement-of-practice-4-1997

16 https://www.gov.uk/government/consultations/deduction-of-income-tax-from-savings-income-implementation-of-the-personal-savings-allowance

4 Remove the obligation to deduct income tax from non-TDSI interest below a specified amount

5 Allow individuals to elect to receive interest with or without deduction of tax

6 Modify the obligation to deduct income tax from non-TDSI income, as part of wider changes to deduction of tax obligations

1.35 The consultation asked respondents to comment on which of the options above would most effectively balance four key drivers:

- Making it as easy as possible for recipients of savings income to pay the right tax
- Minimising risks to the exchequer if the right tax is not paid
- Administrative burdens and costs for payers of interest and other amounts, and
- Costs to HMRC of operating and policing the tax system.

1.36 There was no overall consensus from the responses on the most appropriate outcome. It was considered the making tax digital (MTD) project announced in Budget 2015 would help resolve many of the issues raised, with automatic provision of data pre-populating self-assessment returns and minimising risk to the Exchequer from taxable income not being reported to HMRC.

1.37 The government therefore concluded that rather than making significant immediate changes, it would review withholding arrangements as part of MTD.

1.38 However, from April 2017, withholding was removed from interest on peer-to-peer lending activities, and interest distributions by authorised unit trusts, investment trusts and OEICs. This brought the treatment of these forms of savings income in line with interest on bank and building society accounts.

1.39 The following case study shows the difficulty a compliant taxpayer with relevant income may have in ensuring that they complete an accurate return.

Illustrative case study 3: Eden - receipt of interest

Eden receives the following payments of interest in the 2018/19 tax year:

- Interest on a cash ISA £1,000
- Interest on a bank deposit account £750
- Interest on National Savings Investments £500
- Interest on a compensation payment (for credit card mis-selling) £100
- Cash back for using a credit card £50
- Reward for paying £1,000 into current account £5 per month = £60

In order to complete a self-assessment, Eden is able to confirm on gov.uk that the ISA and the National Savings Interest account are exempt,[17] and understands that the bank deposit interest is now paid gross and qualifies for the personal savings allowance (PSA). However, Eden is unsure whether the other amounts are taxable, and if so whether tax has been deducted and whether the PSA may apply.

So, Eden needs to telephone the bank's call centre, or the HMRC savings helpline, for assistance. The correct answers are out in Table 1.F above.

Dividend income

Background

1.40 The taxation of company dividends paid to shareholders underwent a considerable change in April 2016.

1.41 For many years, the UK had operated a partial imputation system, which imputed to those receiving a dividend some of the underlying corporation tax (CT) paid by the company in the form of a tax credit that could be set against the income tax due on the dividend. From April 1999, the tax credit was restricted to being set off against income tax liability: the credit was not payable to a taxpayer who had no liability (for example, where dividends were covered by the personal allowance).

1.42 The government's business tax roadmap, published in 2016, set out the intention of reducing the rate of CT payable by companies, to 19% from April 2017, and to 17% from April 2020.[18]

1.43 The government had indicated that reducing the rate of CT may mean structural changes would be necessary.

1.44 Accordingly, a change was introduced in April 2016, with dividends no longer carrying a tax credit for the underlying CT paid by the company.

1.45 The following tax rates for dividends now apply for individuals:[19]

- First £2,000 of dividends charged at nil %
- In excess of £2,000 and within the basic rate band – 7.5%, the dividend ordinary rate
- In excess of £2,000 and within the higher rate band – 32.5%, the dividend upper rate
- In excess of £2,000 and within the additional rate band – 38.1%, the dividend additional rate

1.46 As set out above, dividends are treated for the purposes of the income tax calculation as the highest part of the person's income. To avoid the majority

17 See https://www.gov.uk/individual-savings-accounts for ISAs and https://www.nsandi.com/our-products

18 https://www.gov.uk/government/publications/business-tax-road-map

19 S8 and s13A ITA 2007

of taxpayers with modest levels of dividend income being subject to relatively small amounts of tax, a dividend allowance of £5,000 was introduced. This allowance was reduced to £2,000 from April 2018.

1.47 As with the PSA, the dividend allowance is not an exemption from tax but rather a nil rate. The OTS has been told this ensures all dividend income is considered taxable income, which was the case under the previous imputation regime. However, this treatment gives rise to complex calculations in some cases (see examples above).

1.48 Dividend income which is taxed at the nil rate due to the allowance is still counted in arriving at the level of PSA entitlement, income levels for transfer of personal allowance between spouses/civil partners, and the tapering of the personal allowance where total income exceeds £100,000 (although there is no longer a tax credit to add to the dividend in arriving at gross income, which may reduce the amount of tapering compared with the previous regime).

1.49 The previous dividend tax credit system required adding the credit to the value of the dividend and then applying the credit against the income tax payable on the aggregate amount, which was a complexity. The OTS understands that the rationale for the 2016 change included addressing this complexity and the need to reduce tax-motivated incorporation, by increasing the income tax charge on distributions of profit to a similar level to the taxation of profits extracted from unincorporated businesses. The dividend 'allowance' was then created to avoid individual investors having to account for relatively small amounts of tax on their dividend income – the OTS understands that the reduction to £2,000 from April 2018 will still leave around two-thirds of individual investors outside any tax charge.[20]

Foreign dividends

1.50 Foreign dividends may be paid with foreign tax already deducted. A taxpayer who wants to check that tax has been correctly deducted must refer to the double tax treaty between the UK and the country where the dividend was taxed. Where the double tax treaty provides for a lower or nil rate of tax, reclaim of the foreign tax may be made by application to the relevant overseas fiscal authority. In other cases, UK residents may claim foreign tax credit on the self-assessment foreign pages, at the lower of the UK or the overseas rate of tax.

1.51 Where the only foreign income relates to foreign dividends totaling less than £300 and the individual is not required to complete a self-assessment tax return, as these need not be reported to HMRC. No foreign tax credit can be claimed in these circumstances (since there is no double taxation), although where the double tax treaty provides for a lower or nil rate of tax, application may still be made to the relevant fiscal authority. Individuals completing a self-assessment are required to report all dividends, including those which fall within the dividend allowance.

20 Figures shown in Tax Information Impact Note: https://www.gov.uk/government/publications/income-tax-dividend-allowance-reduction/income-tax-dividend-allowance-reduction

1.52 The OTS understands that applications to overseas fiscal authorities for refunds can take several months, or even years, to be processed. The foreign notes to the self-assessment return set out the procedure for claiming relief for the overseas tax.

Observations

1.53 For the large majority of taxpayers who do not have to declare or pay tax on savings income, the UK tax regime works smoothly. However, the various savings and dividend rates, together with the PSA and dividend allowances, mean that the calculation for taxpayers whose income falls into a marginal category is sufficiently complex that HMRC's software has sometimes computed the tax due incorrectly. Few such taxpayers would be able to check their own calculation unaided.

1.54 The savings landscape was reasonably stable before April 2016, with the option of taxable interest on deposits with basic rate tax deduction at source, or the use of a tax-free ISA wrapper or other non-taxed product. The position now, for the investor deciding where to save, is less clear.

1.55 While the introduction of each of these rates and allowances made sense on their own, they have led to unintended consequences as well as greater complexity.

Roadmap

1.56 The OTS considers that further work on options to consolidate some of these rates and allowances should be undertaken. To approach this area in a strategic way, a personal tax roadmap, along similar lines to the business and corporate tax roadmaps currently in place[21] could set out the plans for income tax, including for savings income, and also outline the stages needed to get there.

1.57 Core features of the roadmap could include the development of principles that will be applied in income tax reform; an outline of the government's approach and key changes planned over the period; a timetable for reform and an engagement strategy to ensure strategic oversight of changes as well as consultation on details where appropriate, together with plans to ensure communications and guidance on personal tax support this and are internally consistent. The roadmap would build on the government's strategy to take a more measured approach to tax policy changes, giving citizens greater certainty and stability in planning for the future.[22]

Allocation of allowances

1.58 Much of the confusion on the tax calculation, evidenced by the errors in the self-assessment software, arises from issues about the allocation of the personal allowance. One way of tackling this could be to specify the order in which the allowance is to be deducted, for example in line with the order in

21 https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/509249/business_tax_road_map_final2.pdf

https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/193239/Corporation_tax_road_map.pdf

22 https://www.gov.uk/government/speeches/spring-statement-2018-philip-hammonds-speech

which the components of income are taxed. A drawback is that this would increase the tax due in certain cases.

1.59 A more radical option would be to end the differential tax rates for dividend income. If all taxable income was taxed at the same rates, it would not matter how the personal allowance was used. Making this change would have the effect of increasing the amount of tax due from those who receive amounts of dividend income above the allowance. It would also impact on the taxation of profit extracted as a salary or as a dividend, from family owned companies.[23]

Exemptions or allowances

1.60 Another potentially simpler system would be for the PSA and dividend allowances to be allowances or exemptions (as their names suggest) rather than a nil rate of tax. This would simplify the calculation. Income falling within the allowance would not need to be reported and would not count towards the individual's total income (for example for the purpose of the higher and additional rates). This would be consistent with the trading income and property income allowances introduced in Finance (No 2) Act 2017. However, this would inevitably mean that some taxpayers, who otherwise would have been higher rate taxpayers for the purposes of the PSA and therefore only entitled to the lesser amount, would become entitled to the full allowance, unless the amounts continued to be determined by reference to total income.

Starting rate for savings

1.61 The starting rate applies to relatively few savers, and for many of those the personal savings allowance would in any event be sufficient to prevent tax from applying to their savings income.

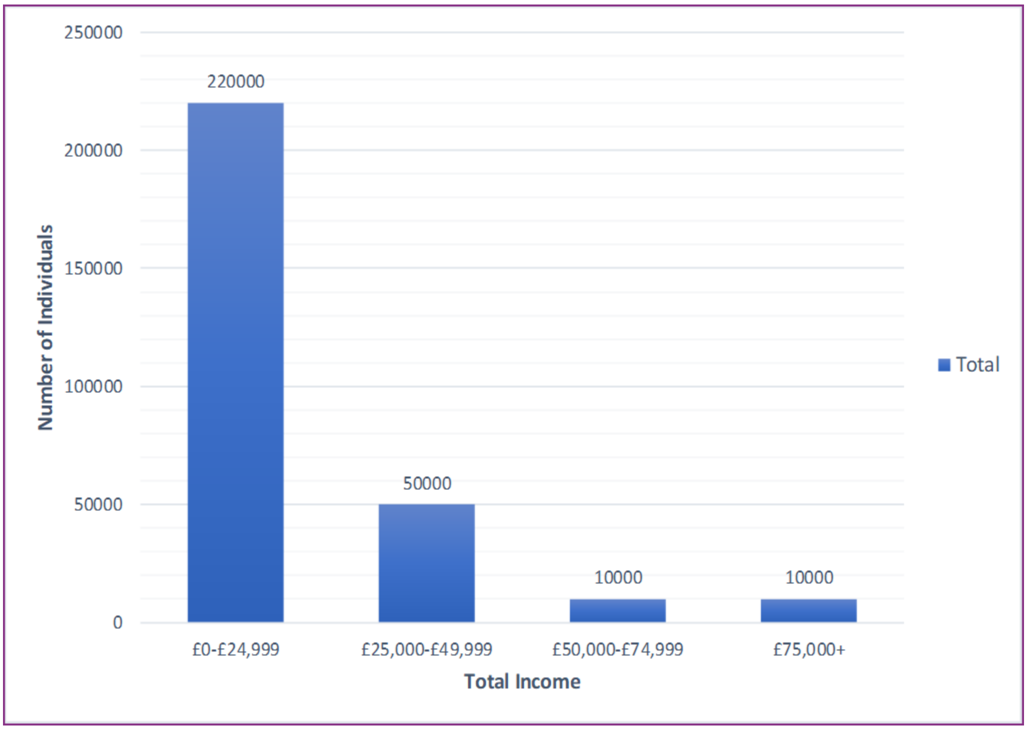
1.62 In order to pay tax at the starting rate, a particular combination of type and level of income is necessary. Taxable earnings, rents and pensions must total less than £5,000 (after personal allowances) while the individual must receive sufficient savings income for it to exceed the level of the PSA of £1,000, suggesting deposit holdings of around £100,000 on current typical interest rates.

1.63 So, who is likely to meet these criteria? The OTS has been told that around 290,000 individuals are currently benefitting from the starting rate for savings, with savings income in excess of the PSA. The charts below look at the total income (all income sources before allowances) and age profile of individuals who would be potentially affected by removal of the starting rate.[24]

23 Annex D of the OTS Small Company taxation review compared profit extraction rates, for salary v dividends v self-employed profits: https://www.gov.uk/government/publications/small-company-taxation-review

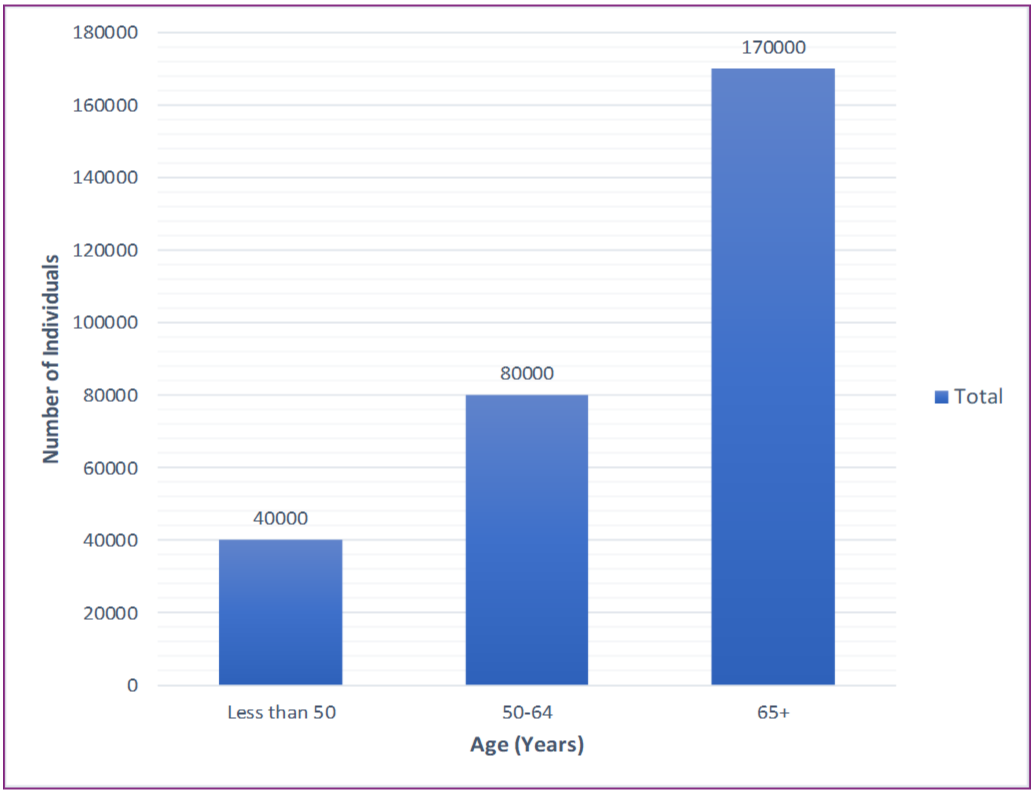
24 Data from HMRC Knowledge, Analysis and Information (KAI), based on projections of 2015 to 2016 Survey of Personal Incomes. Projections are to the year 2018 to 2019, taking account of all policy changes and economic assumptions consistent with the OBR's March 2018 Economic and Fiscal Outlook.

Chart 1.B: Chart showing number of individuals potentially affected by removal of the starting rate, analysed by total income (2018/19)



Source: HMRC

Chart 1.C: Chart showing number of individuals potentially affected by removal of the starting rate, analysed by age (2018/19)



Source: HMRC

1.64 These figures show that a significant proportion of those benefitting from the starting rate have income of less than £25,000 and are aged above 65.

1.65 One relevant situation, a number of cases of which have been drawn to the attention of the OTS, is the position of older people who have sold an asset, such as the family home, in order to move in with relatives or pay for nursing care. For such individuals, the amount of tax payable may not be significant but an additional need to interact with the tax system would be an administrative burden. The OTS notes that simple assessment (once fully introduced[25]) or a coding adjustment (where there are sufficient earnings or occupational pension income) may be possible as an alternative to self-assessment in collecting the tax. These would mitigate any additional burden but not remove it.

Illustrative case study 4: Antonio – savings income

Antonio's only income is the state pension and a small personal pension, totalling £12,000. He is planning to move into a care home. He needs to sell his home, valued at £400,000, to pay the care home fees. The money is placed on deposit, rate of interest 1%, enabling simple transfers into a current account to meet care fees. His family are concerned that he may need to declare and pay tax on the interest.

Although interest of £4,000 per annum exceeds the personal savings allowance of £1000, no tax is due. This is because Antonio's non-savings income is just £12,000. After the deduction of his personal allowance of £11,850, just £150 of income is taxable.

The starting rate for savings applies to up to £5,000 of savings income (minus any taxable non-savings income). £5,000 minus £150 is £4,850, so all of Antonio's interest income would fall within the starting rate for savings and be taxed at the nil rate. No interaction with the tax system is necessary.

1.66 The OTS is conscious of the government's review of care and support for older people, which is due to report in the summer[26] and which will provide further context for consideration of the position of elderly individuals who need to fund their care costs.

1.67 It is not currently possible to accurately estimate the percentage of people who benefit from the starting rate and are using their savings to pay for care costs. If changes were to be made to the starting rate, the impacts on individuals like these would need to be considered.

1.68 Outright removal of the starting rate, with no replacement, would simplify tax legislation and thus remove one potential source of error, but it would not resolve all of the complexities set out in the examples above and could potentially increase tax-related administrative burdens on some older

25 The OTS understands that plans to extend Simple Assessment have been paused, as HMRC re-prioritises its transformation programme in preparation for Brexit. See Qs 123-140 of HMRC's 30 April oral evidence to the Public Accounts Committee http://data.parliament.uk/writtenevidence/committeeevidence.svc/evidencedocument/public-accounts-committee/hmrcs-performance-progress-review/oral/82230.html and this press release from the Association of Accounting Technicians https://www.att.org.uk/hmrc-reprioritisation-simple-assessment-dynamic-coding-paused

26 https://www.gov.uk/government/news/government-to-set-out-proposals-to-reform-care-and-support

individuals. The OTS does not recommend this change to be made in isolation, and considers that a holistic review of the interaction of all savings and dividend rates would be the best approach to simplification in this area.

1.69 Some possible options to simplify the calculation and mitigate undesirable effects of removing the starting rate include:

- Exempting savings interest completely, either for basic rate payers only, or for individuals with total income below a certain threshold, or for individuals over pension age. This is clearly a radical option and would come at a potentially significant cost to the exchequer, which has not yet been quantified. If exemption were linked to the basic rate or an income threshold, this would also create a cliff edge.
- Amalgamating the starting rate with the PSA, resulting in a combined allowance of £6,000 for basic rate payers, or £5,500 for higher rate payers (the higher rate allowance could possibly be reduced further, since the starting rate is less likely to be due in these cases). This option again would have an exchequer cost, currently unquantified.
- People who had sold their family home for the reasons set out above could be encouraged to use their ISA allowances to protect themselves from the compliance burden of accounting for tax on the interest. If a change was announced in the autumn for enactment by the following tax year, £40,000 could be sheltered in ISA accounts for those two years. A longer lead-in time between announcement and implementation would enable further sums to be put into ISAs.
- Finally, a targeted extension to the ISA regime would allow larger sums to be transferred in.

Improved communications

1.70 The OTS saw an example of a query about the rate of tax being applied in respect of a state pension lump sum, (discussed further below) which was complicated by the dividend allowance utilising the basic rate band. The individual concerned was paying no higher rate tax, and therefore assumed the state pension lump sum would be taxed at the basic rate. Although the P800 simple assessment from HMRC correctly arrived at the income tax due (all at 40% as the dividend allowance used up to £5,000 of the basic rate band), it incorrectly showed the rate of tax as 20%, adding to the confusion.

1.71 This is one of a number of examples of unclear or incomplete communication from HMRC in this area. The OTS has started a project to take a strategic look at the approach to taxpayer guidance, in collaboration with work HMRC is itself doing to overhaul its 290 manuals. Gaps in guidance on the tax treatment of savings income, on ISAs and on the treatment of pension income are noted elsewhere in this paper. Given the number of people who have some form of savings income, OTS suggests that this should be an area of priority for HMRC when reviewing guidance and forms.

1.72 The government's Financial Capability Strategy aims to improve financial capacity over time and is building evidence on what works in this context.

There is scope for significant improvement of guidance and education on the taxation of savings to help citizens understand their options and make more informed choices, and the OTS strongly urges HMRC to focus on improving guidance on the taxation of savings income and making it easier to understand, using learning from the Financial Capability Unit where relevant.

Trusts and personal representatives

1.73 It may also be worth considering whether trusts and personal representatives should be entitled to the PSA – even a modest estate will comprise an element of interest on any cash deposit, and the abolition of TDSI means that income tax will need to be paid, with the accompanying administrative burdens on both the personal representatives and HMRC.

Deduction of tax at source

1.74 The MTD timetable has now been revised, with businesses and individuals not being required to enter the regime for income tax until 2020 at the earliest. (The timetable for individuals is not set out but OTS understand that it will not be earlier than for businesses.[27])

1.75 Looking at the balance of convenience referred to above, recipients of small amounts of compensation and other yearly interest are likely to have this income fully covered by the PSA. Those individuals receiving larger payments would be more likely to be liable to higher rates, and so would need to pay further income tax as part of their self-assessment in any case.

1.76 The OTS has been told that real-time pre-population of self-assessment returns from third party information is unlikely in the short term, but that this information will be made available digitally to customers to enable them to meet their self-assessment filing obligations after April 2020. This might enable the removal of the requirement to deduct at source and avoid tax having to be adjusted at year end.

1.77 The OTS suggests this matter be reviewed again now, rather than awaiting further MTD development. It would be helpful to consider deduction at source alongside the rates and allowances with a view to simplifying the rules for all kinds of savings income.

27 https://www.gov.uk/government/publications/making-tax-digital-changing-the-scope-and-pace-technical-note/making-tax-digital-for-business and https://www.gov.uk/government/publications/making-tax-digital/overview-of-making-tax-digital

Chapter 2

Individual Savings Accounts (ISAs)

Background

2.1 Half the UK adult population now hold an ISA.[1]

2.2 There is some evidence of a drop-off in new subscriptions in the last few years: providers attribute the drop in this demand to lower interest rates and the impact of the PSA. However, ISAs continue to be a popular option for savers, with more than 11 million new subscriptions in 2016-17: these numbers clearly illustrate the popularity of these accounts.

Table 2.A: Annual ISA figures

All ISAs			
Year	No. accounts subscribed to in year (thousands)	Amounts subscribed (£million)	Average subscription per account (£)
2008 – 09	15,194	40,094	2,639
2009 – 10	14,437	43,978	3,046
2010 – 11	15,246	53,712	3,523
2011 – 12	14,120	52,883	5,379
2012 – 13	14,902	57,752	5,254
2013 – 14	13,905	57,838	5,590
2014 – 15	13,509	83,821	7,544
2015 – 16	13,395	80,744	7,555
2016 – 17	11,865	62,391	6,639

Source: HMRC.[2] The increased value per account in recent years reflects greater investment in stocks and shares ISAs in particular

1 21.6 million UK citizens held ISAs in the year 2014-2015.
https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/640743/Full_Statistics_Release_August_2017.pdf

2 https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/640723/Table_9.4_Published_August_2017.pdf

Development over time

2.3 ISAs were introduced in 1999 for UK resident individuals aged 18 and over. They replaced Personal Equity Plans (PEPs) and Tax Exempt Special Savings Accounts (TESSAs) and comprised

- Cash ISAs with interest exempt from income tax
- Insurance ISAs with gains exempt from income tax (subsequently incorporated into stocks and shares ISAs), and
- Stocks and Shares ISAs with dividends and interest-bearing qualifying investments exempt from income tax, and gains exempt from capital gains tax

2.4 It was possible to invest in up to 3 mini-ISAs (one component each) with limits of £3,000, £1,000 and £3,000 respectively, or one maxi-ISA with an overall investment limit of £7,000.

2.5 The ISA allowance has increased over the years and was raised to £20,000 from April 2017: other changes permitted flexibility in the annual limit by allowing withdrawals to be replaced without reference to the allowance. Further, additional permitted subscription rules allow the spouse or civil partner of a deceased ISA holder to open a new ISA with an additional allowable amount equal to the value of their partner's ISA at date of death.

2.6 Further ISAs have since been introduced as follows:

Junior ISAs (JISA)

2.7 JISAs have been available to a UK resident child under the age of 18 since November 2011. The subscription limit for 2017/18 is £4,128, and can comprise a cash JISA or a stocks and shares JISA or one of each. The child cannot access the funds until age 18. JISA income does not count towards the parent's income.[3] It is not possible to hold a JISA as well as a Child Trust Fund (CTF). CTFs are no longer available, but holders may continue to invest £4,128 per year. If the customer wishes, a CTF account can be transferred to a JISA.

Help to buy ISA

2.8 Introduced from December 2015 for four years, this is not strictly a new ISA type as it is defined as a cash ISA. Investors from age 16 may save up to £200 per month plus an initial subscription of £1,000. It is available per individual, rather than one per home. A government bonus of 25% on savings is available to first time buyers when buying a UK main residence up to £250,000 (£450,000 in London). The bonus minimum is £400, and the maximum is £3,000. Accounts can be opened until November 2019. Any accounts open at that date will keep tax free status and the bonus on first time home purchase until 2030.

Innovative Finance ISA

2.9 Introduced in April 2016, Innovative Finance ISAs (IFISAs) allow savers to use all or part of their annual allowance to invest in funds lent through FCA-

3 S625 ITTOIA 2005

regulated peer-to-peer lending platforms. Interest and capital gains from such investments are tax-free. The following qualifying investments may be included in IFISAs

- Peer to peer loans
- Crowdfunding debentures

Lifetime ISA

2.10 The Lifetime ISA was introduced in April 2017, and can be used to buy a first home or save for later life. UK resident individuals aged 18 to 40 may invest up to £4,000 annually (as part of their overall ISA allowance), and will receive a government bonus of 25% of the amount put in. The ISA holder can continue to invest until age 50, but if withdrawing any savings below the age of 60, they must pay a withdrawal charge of 25% of the amount withdrawn, unless the money is used as a deposit on a first-time purchase of a UK main residence with a value up to £450,000. The 25% withdrawal charge is more than a simple repayment of the bonus, representing recovery of investment growth.

2.11 It is possible to transfer Help to Buy funds into a Lifetime ISA, or retain both accounts, but only one bonus may be used to purchase the home. During the 2017/18 tax year only, such a transfer of funds in a Help to Buy ISA at 5 April 2017 could be made without counting towards the Lifetime ISA subscription limit.

Observations

2.12 The tax position for investors had been relatively stable for many years, with savers having the option of basic rate tax deducted at source from their interest or investing their money within the tax-free wrapper of an ISA or another tax-relieved savings product. There is clear evidence that ISAs remain a trusted product: however, the introduction of the PSA, combined with historically low interest rates, has encouraged savers to seek out a wider range of products to maximise their returns.

2.13 The OTS considers that there is scope for a wider full review of the current ISA landscape, to make the regime simpler and more accessible.

Increasing flexibility

2.14 The OTS understands that while it is possible to fully transfer one ISA to another without reference to the overall investment limit, that is not the case for all partial withdrawals.

2.15 There is a rule that a customer can normally only open or invest in one ISA of each type in a tax year. For example, if you take out a Help to Buy ISA you can't take out a normal cash ISA (but you can start a Lifetime ISA). This is not always understood by investors, particularly where the overall limit has not been reached.

2.16 An ISA trade body has raised the idea of removing the requirement that an investor can only take out one ISA of each type per year, subject to the overall annual limit. They also noted that an ISA taken out in the current year can only be transferred in full, while an ISA from previous year may be transferred in full or in part.

2.17 The OTS considers further changes can be made to make ISAs rules simpler for investors and easier to administer: these might include enabling partial transfers of money invested in-year, (in line with transfers from previous years' ISAs), removing the requirement that an investor may only take out one ISA of each type per year (subject to the overall annual limit) and facilitating future transfers from Help to Buy to Lifetime ISAs without affecting the annual Lifetime ISA allowance.

Lifetime ISA

2.18 The Lifetime ISA has been welcomed as an alternative or a complement to pension funding for the self-employed, and the OTS has heard calls for the age limit for making new contributions to be increased to 50 or older.

2.19 However, take-up of Lifetime ISAs has been slower than predicted.[4] The OTS understands that the number of LISA managers is still relatively small[5] and that only one provider currently offers a cash version of the Lifetime ISA.

2.20 The Financial Conduct Authority (FCA) issued a Policy Statement (PS17/4) in March 2017 and revised their rules in light of the introduction of the Lifetime ISA.[6] The Policy Statement notes that the LISA combines elements of a short-to-medium-term deposit based savings product with a long-term retail investment product. This combination – together with the early withdrawal charge – are considered to present a number of risks, particularly with regard to complexity and consumer protection. The amended FCA rules include a number of additional safeguards to mitigate the identified risks.

2.21 The Policy Statement was issued following consultation: among other things consultation respondents raised concerns about selling to unadvised customers. The FCA consider that the product might be offered to unadvised investors if sufficient guidance and educational material are provided in advance of purchase, alongside a cooling-off period.

2.22 Notwithstanding the FCA policy paper, major retail banks have told the OTS that they are not comfortable with offering the product to a customer who has not had professional advice on the implications. Unadvised retail investors may not be able to form an assessment of best value at the time of investment, and will be penalised by the withdrawal charge if they change their mind at a later stage. The bank's advice on its own products cannot be considered impartial and there are fears of miss-selling claims.

2.23 In 'Time for Change: A review of the ISA regime' the AAT ISA Working Group noted that they and the FCA are concerned that customers may not understand that the 25% exit charge is not just the clawback of the 25%

4 Office of Budget responsibility November 2017, page 242. http://cdn.obr.uk/Nov2017EFOwebversion-2.pdf

5 https://www.gov.uk/government/publications/list-of-authorised-isa-managers/isas-authorised-managers

6 https://www.fca.org.uk/publication/policy/ps17-04.pdf

bonus, but includes also any returns on the bonus and an additional 6.25% charge on the contribution made by the saver.[7]

Guidance

2.24 Generally, the tax-exempt status of ISAs is well understood. However, the rules regarding transfers can be complex and the range of types of ISA can be confusing.

2.25 The OTS notes the gov.uk guidance page may cause confusion when stating there are four types of ISAs: cash, stocks and shares, innovative finance and lifetime ISAs. Although this is technically correct, there are other named ISA products: a helpsheet on Help to Buy ISAs can be found by running a search, and there is a link from the ISA page to Junior ISAs. It would be clearer to show all of these in one place.

2.26 The OTS considers it important that taxpayers are enabled to understand the implications of tax-advantaged products such as LISAs and to make an informed decision. The concerns expressed by financial providers and others about the LISA product are worth further exploration.

2.27 People saving for their first home currently have a choice between Help to Buy and Lifetime ISAs. Both schemes offer a matching contribution from the government subject to conditions. The schemes' conditions are different, and investors in different circumstances may benefit from one rather than the other. It will not be possible to open a Help to Buy ISA after 30 November 2019, but holders will be able to continue to save into existing accounts after then. It is possible to transfer funds from a Help to Buy ISA into a Lifetime ISA without a penalty, but transfers from a Lifetime ISA into a Help to Buy ISA incur a 25% withdrawal charge.[8] It appears that the Help to Buy ISA is being phased out in favour of the Lifetime ISA although there is no clear statement on this point on the relevant pages of gov.uk.

2.28 The OTS welcome the ISA flexibility introduced in April 2016. This permits savers to replace cash they have withdrawn earlier in the tax year without this replacement counting towards the annual investment allowance (although there is no obligation on providers to offer this facility, and some do not).

Digital Identity

2.29 The Open Banking Project will enable customers to allow third parties access to their financial accounts to facilitate price comparisons and money management.[9] Financial providers have suggested that a digital ID for customers would simplify the process. One way of addressing this may be to require the customer's national insurance number whenever a product is taken out (already required for ISAs) – which may also feed in to HMRC's digital agenda. More effective use of existing information could also facilitate the simplifications in ISA rules discussed above.

7 See page 10 at https://www.aat.org.uk/prod/s3fs-public/assets/AAT-ISA-Working-Group-Time-change-review-ISA-regime.pdf

8 https://www.gov.uk/lifetime-isa

9 https://www.openbanking.org.uk/home/what-is-open-banking/

Chapter 3
Pension income

Background

3.1 Tax is payable on most pension income to the extent that it exceeds the pensioner's personal tax-free allowance. In many cases the receipt of pension income is the first time a taxpayer, whose income previously was taxed under PAYE, will have had to engage with the tax system and make payments to HMRC in a personal capacity.[1]

3.2 There is evidence of widespread confusion about pensions, including research by the Financial Conduct Authority[2] and the records of a low income taxpayer representative body (for whom pension questions make up more than half the queries they receive about savings issues). In this regard, the tax treatment of lump sums is a particular cause of concern.

3.3 This section of the paper considers:

- The taxation of withdrawals from personal pensions, and
- The taxation of lump sums from deferred state pensions

Personal pension lump sum withdrawals

3.4 The introduction of pension fund flexibility in relation to defined contribution pension schemes was a major change to the pensions landscape.

3.5 A defined contribution (DC) scheme is one where the investment return from the pension fund is based on contributions and is not guaranteed. (Alternatively, some pension schemes have defined benefits, for example a guarantee that someone with scheme contributions for a given number of years will get a specific percentage of their final salary on retirement.)

3.6 From 6 April 2015, an individual with a DC personal pension may access their funds on reaching the normal minimum pension age of 55 (or earlier in the case of ill-health, or where a protected pension age applies).

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1 The OTS Pensioners Taxation Review looked in depth at this subject in 2014. https://www.gov.uk/government/publications/taxation-of-pensioners-review This paper considers more recent changes and issues arising from those.

2 In their 2017 Finance Lives Survey, the Financial Conduct Authority found that 25% of people who had accessed a defined contribution pension in the last year were not sure how they had accessed it - they get an income or have taken a cash lump sum from their pension, but are not sure how this works. https://www.fca.org.uk/publication/research/financial-lives-survey-2017.pdf (page 129).

3.7 Subject to the rules of the scheme, the individual may access it either by taking funds as a single lump sum, or a number of lump sums over a period of time. These withdrawn lump sums, taken together, cannot exceed the amount of the individual's lifetime allowance.[3] Any funds remaining after withdrawals may then be used more conventionally, with a 25% tax free lump sum and the balance to buy an annuity or to enter into a drawdown arrangement (where the pension provider allows the saver to access a regular adjustable income from the fund).

3.8 The tax treatment of any lump sums withdrawn is as follows:

- 25% is tax-free
- The remainder is subject to income tax as pension income (the scheme provider deducting income tax under PAYE)

3.9 29% of those who accessed a defined contribution pension in the last two years withdrew a lump sum.[4] Data collected by the Financial Conduct Authority suggests the trend is increasing, with over 150,000 people who accessed a personal defined contribution pension for the first time between October 2016 and March 2017 withdrawing cash lump sums (57.5 of the total).

3.10 The majority of those taking lump sums were withdrawing all the money held in small pension pots. FCA data tables show that 37% of those who withdrew money from pensions in the last two years expect the State Pension to be their main source of income: the treatment of lump sums is therefore an issue that affects a sizeable number of people, many with small amounts of income and savings.[5]

Observations

3.11 When applying PAYE to pension income, the provider will use the code number shown on a form P45 for the current tax year, if this is provided by the individual. However, this information is unlikely to be held at the time a lump sum is withdrawn, so in practice an emergency code is often applied - which operates on the basis that this sum will be received every month.

3.12 This means subsequent adjustments are normally required, and in most cases taxpayers will have overpaid tax. A lump sum may represent many years' worth of pension income, so higher rates of tax may be deducted on the basis of an emergency coding. The OTS has been told that £37m of tax has been repaid following overpayments of tax on pension lump sum withdrawals since the April 2015 changes.

3.13 The OTS has seen two schools of thought on this.

3.14 Those representing low income taxpayers considered that it was important to minimise the risk that over-payments might need to be clawed back from

3 The current lifetime allowance is £1 million, although it has been possible to protect a higher allowance from legislative reductions

4 https://www.fca.org.uk/publication/research/financial-lives-survey-2017.pdf See pages 129 and 130 and figure 8.15. See also https://www.fca.org.uk/publication/data/data-bulletin-issue-10.pdf for the six months from October 2016 to March 2017.

5 https://www.fca.org.uk/publications/research/understanding-financial-lives-uk-adults

taxpayers with no savings. There was a danger the money would be spent shortly after receipt and it was better to over-deduct tax in the first instance, rather than risk getting low income taxpayers into debt by overpaying them.

3.15 However, pension industry representatives felt that where it was not possible to operate the correct code for the individual, a default code at the basic rate would mean those basic rate taxpayers would have the correct amount deducted, and the higher rate taxpayers who would need to pay more later would often already be used to dealing with self-assessment.

3.16 HMRC advise that dynamic coding,[6] enabling tax underpayments and overpayments to be cleared in year, will result in more people having a balanced tax position at the end of the tax year. However, it will not end the use of emergency codes on lump sum withdrawals from pension funds. HMRC have told the OTS that they are currently making repayments in response to claims of overpaid tax on lump sum withdrawals within 7 days: stakeholders have told the OTS that delays of up to 6 weeks are still being experienced in some cases.

3.17 The fact that the taxation of pension lump sums is not easily understood by many recipients results in many queries as well as claims for repayment. It is quite possible that some pensioners do not make claims due to a lack of understanding of the correct tax treatment. A repayment after the end of the tax year would normally be made in these cases.

Illustrative case study 5: Ossie – Personal pension withdrawal

Ossie has an annual income of £25,000. He has a pension fund of £100,000, and has read about new pension freedoms, allowing him to withdraw all or part of the fund.

Ossie needs a new car, and would like to withdraw £10,000. He approaches the pension provider, who confirms they offer a partial withdrawal (some do not) and informs him that 25% of each withdrawal is free of tax, but the remainder would be taxed as part of his total income.

Ossie checks on the gov.uk website, on the Pensionwise pages, and follows the calculator which shows that a withdrawal of £10,000 would result in a tax liability of £1,500, leaving a net payment of £8,500. Ossie authorises the withdrawal to be made, but the amount of the net payment is only £7,600, due to the operation of an emergency code.

As a result, Ossie is currently unable to purchase the car. He follows the links from the gov.uk page to 'claiming tax back',[7] which talks about the various different forms he might need to use depending on his situation.

These are: a form P800 (received after the end of the tax year) if taking a personal pension; form P50 for a state pension; form P53 for a defined benefit (occupational final salary) scheme; form P53Z defined contribution (personal

6 Introduced in the summer of 2017.

7 https://www.gov.uk/claim-tax-refund/you-get-a-pension

pension) lump sum if taking all of the pot; and finally form P55 (defined contribution lump sum, not taking all of the pot) which is the one to use in his case. The pages do not show the time taken to repay.

Lump sum withdrawals from deferred state pensions

3.18 Individuals who reached state pension age before 6 April 2016 and have deferred drawing their state pension, have a choice of drawing a higher weekly state pension which is taxed in the normal way, or receiving a lump sum of the amount not claimed, plus an interest element of 2% over the bank base rate.[8] The particular tax issues set out below are limited to this population of individuals at the point they draw the lump sum.

3.19 Special tax rules will apply to these lump sum payments: the rules are set out in sections 7-9, Finance (No.2) Act 2005. The whole lump sum is taxed as pension income, rather than the interest element being taxed as savings income. To prevent any impact on the operation of age-related allowances, the lump sum is not taken into account in determining total income.

3.20 The lump sum is taxable in the year the individual is entitled to receive it (or, in the case of death before receipt, in the tax year of death).[9] However, the taxpayer has the right to elect, within one month of starting to claim the deferred pension, to defer payment and taxation of the lump sum to the following tax year. The lump sum is taxed at the taxpayer's highest tax rate, but its receipt will not push the taxpayer into a higher rate category, as set out in the following table:

Table 3.A: Taxation of state pension lump sums

Total income (ignoring lump sum)	Rate at which lump sum is taxed
Less than tax-free personal allowance[10]	Nil
Greater than personal allowance, but not exceeding the basic rate limit	20%
Greater than the basic rate limit, but not exceeding the higher rate limit	40%
Greater than the higher rate limit	45%

Source: OTS

3.21 For Scottish and Welsh taxpayers, the rate is determined by the Scottish/Welsh rates respectively.

8 Schedule 11 Pensions Act 2004

9 Any deferred pension will be inherited by a surviving spouse or civil partner. If there is no surviving spouse or partner, deferred pension income will only be part of an estate (and so inheritable by a beneficiary other than a spouse or civil partner) if the pensioner had claimed it before death. https://www.gov.uk/deferring-state-pension/tax-and-inheritance

10 https://www.gov.uk/income-tax-rates

3.22 Tax is deducted from the lump sum by the Department for Work and Pensions (DWP) under a modified PAYE scheme. HMRC guidance[11] states that DWP will operate the rate of tax declared by the pensioner, either on a paper form or over the telephone. In the absence of a declaration, basic rate tax is deducted. DWP do not operate the Scottish rates of income tax. The OTS understands that from 6 April 2018 pensioners will be asked to nominate either 20% or 40% even if they are Scottish taxpayers.

3.23 If tax has been overpaid, the individual can apply for an in-year repayment by completing form P50. If tax has been underpaid, HMRC will calculate the amount the pensioner needs to pay back and tell them how the underpayment will be collected.

Observations

3.24 Clearly, the tax year in which the lump sum is taken can alter the rate of tax applicable. As discussed above, any income untaxed because of the application of the PSA and dividend allowances still counts towards total income for the purpose of determining the rate at which the lump sum is taxed. This may result in a different rate applying to the one expected. There are also other potential areas for confusion. For example, gift aid and pension contributions do not reduce the taxable income in arriving at the rates above.

3.25 The OTS has seen a query raised relating to a state pension lump sum payable when an election to transfer 10% of the personal allowance to a spouse or civil partner had been made – in this situation the transferring partner will have a reduced allowance which may trigger a higher tax rate than expected, while the transferee partner receives the benefit of enhanced allowance by way of a reduction in the amount of tax payable rather by reducing taxable income, which means the taxable income in the table above does not change as might have been expected.

3.26 For example, in 2018/19 the personal allowance is £11,850, and a claim to transfer 10% of the allowance to a spouse or civil partner would result in the transferor's allowance being reduced to £10,660. If other income totalled £11,000, say, a state pension lump sum received by the transferor would be liable to income tax at 20%, but had no transfer of allowance taken place, the rate of tax would be nil.

3.27 However, there is no converse to the above where the transferee receives a state pension lump sum. Their personal allowance for the purposes of determining the rate of tax to be applied to the lump sum remains at £11,850, despite the transfer of £1,190 from the spouse or civil partner. If other income totalled, say, £12,000, the rate of tax applied would remain at 20%, and the additional relief for the amount transferred would be given as a tax reduction of £238 (£1,190 at 20%) from the total liability due.

3.28 If the PSA and dividend nil-rates were to become allowances in a similar manner to the trading and property allowances (see dividend section above),

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11 https://www.gov.uk/hmrc-internal-manuals/paye-manual/paye94090

it would reduce some of the confusion in arriving at the applicable tax rate on state pension lump sums.

3.29 The fact that DWP will not operate the Scottish and Welsh rates of tax for relevant taxpayers will result in underpayments and overpayments of tax in different circumstances.

3.30 However, this issue is relevant only to those individuals who reached state pension age before 6 April 2016, and who have decided to defer. The number of such people is clearly now limited. For those entitled to the new state pension from 6 April 2016, a claim to defer would result in a higher weekly amount due when claimed, which would be taxed in the normal way.

3.31 The OTS notes that guidance on the tax treatment of state pension lump sums is very difficult to locate – the starting point for most pensioners would be gov.uk, but the pages on deferring the state pension do not cover taxation. While there is a link on tax, the linked pages refer to the taxation of pensions generally. They do not explain how lump sums are taxed and do not set out the option to elect to defer the taxation of the lump sum.[12] Good guidance that helps taxpayers understand their tax calculations and comply with their obligations, for example by highlighting particularly relevant matters, would be beneficial to both HMRC and its customers, reducing the need for them to contact HMRC directly. Guidance on the taxation of pension income is an area that might helpfully be prioritised, particularly given the Financial Conduct Authority findings (referred to above) that a significant proportion of the UK population struggles to understand the basic details of their pensions.

3.32 The OTS would welcome the opportunity to work with HMRC and other stakeholders on options to simplify the tax treatment of pension income and make it more comprehensible to pensioners.

12 https://www.gov.uk/tax-on-pension/how-your-tax-is-paid

Chapter 4

Life insurance bond withdrawals

Background

4.1 A life insurance bond is a single premium life insurance policy held for investment purposes.

4.2 In general, a life insurance policy is a contract between a life insurance company and an individual or individuals, where the insurance company will make a payment in return for premiums paid, dependent on the expected duration of a human life or lives.

4.3 Broadly, these life policies fall into three classifications:

- Term assurance, taken out to insure against death within a specific period,
- Whole of life, with payment being made on death of the person assured whenever that occurs
- Endowment, which will mature and pay out after a fixed period, or on death of the person assured, if earlier

4.4 The second and third of these are effectively a mix of life cover and investment, and include the option of cashing in during the period of the policy for a surrender value.

4.5 A significant proportion of the population hold policies falling into these categories. The OTS has not been able to establish the number of endowment policies held, but whole of life policies are held by approximately 10% of the UK adult population.[1] The life insurance single premium bonds are normally written as whole of life contracts, which enable the investor to continue the contract as long as is required, with the option to cash in at any time.

Taxation

4.6 The legislation distinguishes between life insurance contracts focused on life cover and those primarily directed at investment. The former achieve qualifying status if certain conditions are satisfied (concerning the amounts and regularity of the premiums paid).[2] The significance of qualifying status is whether gains arising on life policies are taxable.

1 https://www.fca.org.uk/publication/research/financial-lives-survey-2017.pdf See page 130. Note that 10% = 28% (of UK population who hold life insurance policies) x 35% (of that number who have whole of life policies) = 9.8%, rounded to 10.

2 Schedule 15 ICTA 1998

4.7 Deciding whether or not the policy is qualifying is not an issue for the individual policyholder, since the insurance company will advise the investor of the position.

4.8 A gain arises from a policy where a capital sum received from the policy exceeds the premiums paid to date. Such gains can arise in a variety of situations, known as chargeable events, and are generally chargeable to income tax. However, in relation to qualifying policies, they are chargeable only where contributions are discontinued into the policy within 10 years of making the contract, or if sooner, three-quarters of the term the policy is to run.[3]

4.9 For non-qualifying policies, all of the following are taxable chargeable events, and subject to income tax:

- death
- maturity
- surrender (or certain part surrenders)
- policy loan – from the life insurance provider, based on the security of the policy
- assignment for money or money's worth

4.10 The amount of gain chargeable to income tax in the case of death, maturity, surrender, assignment, or taking a capital sum as a complete alternative to annuity payments, will be the amount received or surrender value, plus any capital benefits already received, less premiums paid and the value of any previous chargeable event gains.

4.11 There are no provisions to claim loss relief on a bond, although deficiency relief is available on death, maturity or surrender of the bond where the gain chargeable calculation above results in a deficiency. In such cases some relief is available up to the amount of previous chargeable event gains.

4.12 The relief is only available to higher or additional rate taxpayers, and is given as a reduction of tax chargeable by attributing the deficiency to that amount of income, at the difference between the higher rate and the basic rate. For example, relief on a deficiency of £10,000 claimed by an individual liable to the higher rate on employment income would result in a tax reduction of £2,000 (£10,000 at 40%, less basic rate 20%). This sum could be offset against any tax due in the year the deficiency arises.

4.13 Chargeable event gains can also occur on part surrender, but are calculated differently. The gain arising will be the difference between the total amount withdrawn from the policy, and 5% of the premiums paid per year since the policy was taken out (up to a maximum of 20 years).

4.14 Part surrenders in excess of the 5% of premiums allowance can produce gains even where the value of the policy has fallen.

3 S485 ITTOIA 2005

4.15 The amount of the chargeable event gain is normally set out on a certificate sent to the policyholder by the insurance company. The gain is subject to income tax as savings income, and falls within the scope of the PSA. Capital gains tax is not chargeable on the gain, unless the person making the disposal was not the original beneficial owner, and acquired the policy for consideration in money or money's worth.

4.16 For UK policies, the gain is treated as having had basic rate tax deducted from it at source. In these cases, further liability will only arise at the higher and additional rates. Such a gain may cover several years' growth on the bond, so the legislation smooths the potential effect of this through what is called 'top slicing' relief. This operates where an individual without the gain would have been charged at the basic rate, but the gain takes them into higher rates, or where they would have been charged at the higher rate but the gain takes them into the additional rate. An explanation of how the relief operates is set out in HMRC helpsheet HS320.

Illustrative case study 6: Henrietta – life insurance bonds

Henrietta invests £100,000 in a policy on 15 April 2016, and withdraws £75,000 on 17 August 2017, at which point the policy is worth £104,167. The chargeable event gain will be £75,000 (less one year at 5% of £100,000), a gain of £70,000, which is likely to be disproportionate to any underlying gain.

This notional gain would remain taxable even if the value of the bond was standing at a loss.

In Henrietta's case, a more equitable result would be secured if the policy had been set up in the form of a number of segments, and instead of a partial surrender needing to run across all segments (horizontal) producing the anomalous result, a decision is possible to fully encash a suitable number of whole segments (vertically).

The current surrender value of Henrietta's bond is £104,167, and the policy is divided into 100 segments. If the withdrawal of £75,000 is made vertically by fully encashing 72 segments, the gain on each would be £41.67 (£1,041.67 - £1,000), totaling £3,000 overall. This is a considerable reduction compared with the gain on the horizontal calculation.

Assuming Henrietta's other income made her a higher rate taxpayer before these gains, which do not take her into the additional rate (so no top-slicing relief is due), with no other savings income, the tax charge on the vertical calculation gain would be £500 at 0%, £2,500 at 40%, less 20% if a UK bond, = £500, or on the horizontal calculation £500 at 0%, £69,500 at 40%, less 20% if a UK bond, = £13,900.

4.17 In a case where there was no audit trail showing the use of vertical surrenders, the First-tier Tribunal[4] held that the default position in general

4 Rogers v HMRC [2011] UKFTT 791 (TC)

law is for partial (horizontal) encashments to be assumed to have taken place.

4.18 The Upper Tribunal in the judgement of Lobler v HMRC [2015] UKUT 152 (TCC) severely criticised the taxation regime on partial surrenders, and effectively allowed rectification of the partial surrender in question, allowing vertical encashment taxation treatment.

4.19 Following that decision, HMRC launched a consultation 20 April 2016 into part surrenders and part assignments of life insurance policies, putting forward three options for change.[5] On considering the responses, and mindful of the increased education and support available from life companies and independent financial advisers about the potential tax consequences of early encashments, a change to the tax rules for all policyholders was not considered appropriate. Instead, the small number of policyholders who may find themselves in the position of having a gain on part surrender which is 'wholly disproportionate', may apply to HMRC for adjustments to be made on a just and reasonable basis. This change in legislation was included within Finance (No 2) Act 2017.[6]

4.20 The OTS understand that disproportionate gains are a relatively rare occurrence. Bond providers work to ensure that customers understand the implications of withdrawals above the 5% cumulative allowance. Both insurers and HMRC are monitoring the position: the OTS understands that HMRC have received around 15 applications since the new process was introduced. The small numbers and range of circumstances mean it is not currently possible to give a standard anonymised example.

4.21 Personal portfolio bonds, where the bond holder chooses the underlying investments, are subject to special rules, including an annual tax charge of 15% of premiums paid, with the premium being treated as increased at 15% per year on a compound basis, until the penultimate insurance year.

Observations

4.22 OTS understands that many individuals hold life insurance bonds.

Top slicing relief

4.23 A software provider told us that the self-assessment calculator incorrectly deals with the interaction of top slicing relief with the PSA and the starting rate. This applied to 2016/17, and an exception to online filing continued to apply in these cases for 2017/18, so that a paper self-assessment was necessary. However, the OTS understands the issue will be rectified for 2018/19. It is thought some substantial overpayments of tax had occurred, with special back-dated claims required.

4.24 The OTS received a suggestion of removing the top slicing relief calculation and replacing it with a flat rate tax charge on all bond withdrawals. In some cases, top slicing relief can have the effect that people pay no tax at all on substantial gains. Replacing the relief with a single flat rate would remove a

5 https://www.gov.uk/government/consultations/part-surrenders-and-part-assignments-of-life-insurance-policies

6 Section 9, which makes relevant insertions and changes to ITTOIA 2005.

complex calculation from the tax code, but the tax change would result in winners and losers compared with the current regime. Further, this would not reward those that hold the bond for longer periods of time relative to short-term investors and this investment product is intended as a long-term option. A flat rate that increased every 5 or 10 years to a maximum level would reward longer term investment while still representing a simplification relative to the existing regime.

Partial withdrawals

4.25 The annual allowance of 5% of premiums paid is helpful in minimising the impact of part withdrawals. However, the OTS was informed that changes to adviser charges following the retail distribution review resulted in adviser fees coming from the amount of the withdrawal – so in order for the policyholder to receive an amount of 5%, a withdrawal of, say, 5.5% would be necessary to cover the fee, resulting in a potential tax charge.[7]

4.26 The OTS was told that life insurance providers are encouraged to use segmented policies which are flexible, allowing for either vertical or horizontal withdrawals. However, policyholders still need to understand the difference in tax calculation that would occur on these alternative cases. Some people receive advice from their independent financial adviser, but equally some may make a withdrawal without reference to an adviser. The Association of British Insurers (ABI) has published a good practice guidance note, which advises members to use segmented policies and offer customers alternative calculations to help them make informed decisions.[8] The OTS understands that similar practice is adopted by the Association of International Life Offices.

Illustrative case study 7: William – Life insurance bond withdrawals

William has two separate life insurance bonds, and makes a partial withdrawal from each. The two life companies each provide him with a chargeable event certificate.

William's total income, without the gains on the bonds, falls within the basic rate band. However, aggregating the two gains would take William into the higher rates.

William has seen from form HS320 that this scenario would qualify for top-slicing relief. Following the link to the HMRC manual IPTM3840, William can see an example of the calculation, but having more than one such gain means the separate 'annual equivalent' figures cannot be shown on the self-assessment additional information form SA101. William will need to make a white space entry (as directed on the self-assessment notes) and pay tax without top slicing, which HMRC will later adjust. Alternatively, he or his agent could buy special commercial software for the purpose of submitting his self-assessment return.

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7 https://www.fca.org.uk/publication/finalised-guidance/fg12-15.pdf

8 https://www.abi.org.uk/globalassets/sitecore/files/documents/publications/public/2015/taxation/cluster-policies.pdf

4.27 It is in the nature of an exercise of discretion that it does not carry a right of appeal. Customers who are dissatisfied with HMRC's decision on a part surrender may complain to the Adjudicator's Office, and if dissatisfied with the Adjudicator's decision they may ask their MP to refer the matter to the Parliamentary and Health Service Ombudsman. There is also an option to seek a judicial review of the decision.

4.28 The Adjudicator's Office Annual Report for 2017 identifies concerns with HMRC's application of its discretion.[9] HMRC has set up a specially-trained team to deal with applications for relief, and have a range of additional internal controls to ensure that decisions are soundly-based. They maintain a record of applications and decisions so they can monitor the process and make any adjustments deemed necessary (no cause for adjustment has been identified to date).

4.29 The changes in Finance (No. 2) Act 2017 offer the possibility of relief for the small number of cases where the law produces a wholly disproportionate gain. This is welcome, but the OTS considers it would have been preferable for the legislation not to result in disproportionate gains.

4.30 In making this observation, the OTS is conscious that policyholder taxation cannot be separated from the way life insurance companies are taxed (known as the I minus E basis), which broadly operates to secure from the companies the income tax treated as deducted from chargeable event gains.

4.31 The calculation of chargeable event gains has remained virtually the same for some 40 years and appears well understood by the life companies, who are able to offer support and education to their policyholders. The OTS welcomes the ABI best practice guidance, which should ensure that very few policy holders find themselves in the position of having a disproportionate gain.

4.32 However, having distinct calculations for full and for partial surrenders is a significant complication, and relying on HMRC discretion for review on a just and reasonable basis is not an ideal solution. It is possible that some taxpayers do not realise that relief is available for excessive gains and simply accept the position as presented to them.

4.33 The annual 5% allowance for withdrawals has been a core design feature of insurance bonds, encouraging long-term investment while enabling policyholders to withdraw relatively small sums as needed without incurring significant amounts of tax.

4.34 For partial withdrawals above the cumulative 5% allowance, attempting to calculate the proportion of any economic gain that should be attributed to that withdrawal is potentially complex, both at the point of withdrawal and at the end of the policy when a finalised gain calculation is needed. HMRC's consultation document set out a number of examples of how this might

9 http://www.adjudicatorsoffice.gov.uk/pdf/report2017.pdf See pages 14 and 15 and Case Studies 1 and 5.

work in Chapter 3: Taxing the economic gain.[10] The complexity meant that this option was favoured by very few respondents to the consultation.

4.35 An administrative option to simplify the taxation of partial withdrawals without substantially changing the tax calculation would be to mandate a vertical calculation in cases where the withdrawal exceeded the cumulative 5% allowance. This would remove the potential for disproportionate gains and apply a consistent approach. However, it is possible that encashing segments in this way would cause a tax charge to arise in circumstances where horizontal encashments would not.

4.36 The way in which the gains on such policies interact with the tax system is complex, and the OTS believes that this area of savings taxation warrants further review once the new system has bedded down.

10 https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/517920/Part_surrenders_part_assignments_life_insurance_policies.pdf

Chapter 5
Collective investment schemes

Background

5.1 Collective Investment Schemes allow investors to pool their assets together under common management and benefit from their share of the income and gains arising, and can take various forms.

5.2 An authorised fund is one authorised by the Financial Conduct Authority (FCA), and can take one of three forms:

- An investment company with variable capital, known as an Open-Ended Investment Company (OEIC),
- An authorised unit trust
- An authorised contractual scheme (co-ownership or limited partnership schemes, under which all income and expenses arise directly on the investors for taxation purposes)

5.3 The taxation of authorised unit trusts, OEICs and offshore funds differs according to the composition of the fund.[1] Distributions from funds holding a mixed portfolio of interest-bearing and other assets are taxed as dividends where (broadly) equities account for 40% or more of the investments. Where interest-bearing assets exceed 60%, the distributions are taxed as yearly interest.

5.4 The tax treatment will then follow the usual rules for interest and dividends, discussed in earlier sections of this paper. FA 2017 removed the obligation for authorised unit trusts and OEICs to deduct income tax from the yearly interest on their distributions.[2]

5.5 An unauthorised unit trust will either be exempt (where trustees are UK resident and all investors are exempt from tax for reasons other than residence), or non-exempt.

5.6 Non-exempt unauthorised unit trusts (NEUUT) are treated as a UK resident company, and the unit holders as holding shares in a company.[3] Consequently, distributions by the NEUUT are taxed as dividends received by the unit holder.

1 S373-379, 386-391 ITTIOA 2005

2 S888C & D ITA 2007

3 Statutory Instrument 2013/2819

5.7 The OTS has looked at this area of savings taxation and to date no significant observations have been received, aside from the interest and dividend taxation issues raised in earlier sections of this paper. The OTS has been told that the reason is likely to be that the customer receives a consolidated tax voucher from the fund provider, which offers the figures needed for tax reporting purposes.

Annex A
Stakeholder list

ABI

Aviva

HMRC

HM Treasury

LITRG

Liverpool Victoria

Lloyds Banking Group

Old Mutual Wealth

Pavey Group

Prudential

Tim Good

Tax Help for Older People

Tim Hutchence, FPFS

TISA