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Favoured Methods

78.1 Introduction

The UK has a number of tax rules designed to encourage saving. These rules are considered in this chapter and in chapters seventy-nine and eighty below. One interesting side-effect of this encouragement to save has been that people often end up with a larger estate when they die. The tax rules are designed to give relief from income tax and/or CGT, not IHT. So the Chancellor may take three times as much in IHT as he gives away in the other taxes.[1] This chapter covers the UK tax treatment of certain favoured forms of saving. The treatment of—and of income from—investment intermediaries is discussed briefly in chapter seventy-nine below. The division between chapters seventy-eight and seventy-nine is not precise. The extent of these rules, and in particular the extent of the exemptions and reliefs, is made very clear by the gathering together of the material in ITTOIA 2005, Part 4 (savings and investment income) and Part 6 (exempt income). However, the boundary between a rule prescribing the limits of a section, and so to be found in Part 4, and an exemption, to be found in Part 6, is not precise, and so the arrangement adopted in previous editions has largely been followed here. The treatment of the biggest tax privileges of all, those for pension arrangements, was completely rewritten by FA 2004 and took effect in April 2005; this treatment is outlined in chapter eighty below.

The correct tax treatment of income from savings is a highly contentious issue, marking, as it does, the divide between comprehensive income tax (CIT) and expenditure tax (ET). Thus the debate is a reflection of that larger debate: partly a belief that income from saving is doubly taxed, since savings are usually made out of taxed income; and partly a belief that saving is a good thing and so should be encouraged. In the UK there is a strong government wish to encourage saving for retirement, and one strand of the debate is whether such savings should be compulsory. The strongest objection to compulsion comes from the very people whom the Government sees as most in need of having such savings, ie those at the lower end of the income scale. This leaves those who would save anyway as the people who object much less to compulsion. Thus, government policy confounds itself.

[1] *Sunday Times*, 4 February 2007, Money Section.

Tax encouragement to save may take many forms:

(1) the annual return received by the investor may be free, in whole or in part, from income tax;
(2) there may be an income tax deduction, in whole or in part, for the sum invested;[2]
(3) the sum received on disposal may be exempt, in whole or in part, from CGT.

In addition:

(4) the entity with which the money is invested may be free of tax on its income and or capital gains; and
(5) the CGT liability normally arising on a disposal may be deferred on a reinvestment.

78.2 Current UK Savings Incentives

With the introduction of the Personal Savings Allowance (PSA) from 6 April 2016, basic-rate taxpayers do not pay tax on the first £1,000 of savings income such as interest earned on bank current and savings accounts. Higher-rate taxpayers can earn up to £500 of savings income tax-free but additional-rate taxpayers have no tax-free allowance. As a result, the vast majority of taxpayers pay no tax on their ordinary savings income. In addition, income and capital gains from particular forms of savings are exempt from tax, as follows (the ITTOIA provisions apply for income tax, while TA 1988 and later legislation still apply for corporation tax where relevant):

(1) Interest and bonuses on National Savings Certificates; maturity bonuses on defence bonds, British savings bonds and national development bonds; and, for persons resident and ordinarily resident in Northern Ireland, Ulster Savings Certificates.[3]
(2) SAYE interest and bonuses under certain certified contractual savings schemes; for schemes certified on or after 1 December 1994,[4] exemption is limited to savings-related arrangements linked to share option schemes within ITEPA 2003.[5]
(3) Capital gains from government stocks and qualifying corporate bonds.[6]
(4) Income and capital gains of authorised pension and retirement benefit schemes.
(5) Income and capital gains on investments held under an individual investment plans, ie ISAs and formerly personal equity plans (PEP) and TESSAs[7] (see §78.3 below).

[2] There is no CGT deduction until the disposal—unless, perhaps, rollovers are treated as a form of deduction since the investment is greater by the amount of the tax not charged.

[3] ITTOIA 2005, Pt 6, Ch 2, ss 692 and 693, ex TA 1988, s 46 (still in force for corporation tax). See Explanatory Notes Draft Bill, changes 122 and 123. ITTOIA 2005, s 693 makes statutory the former concessionary relief for accumulated interest on Ulster Savings Certificates following the death of the holder (ex ESC A34). An exemption for National Savings Bank interest up to £70 on ordinary accounts (formerly ITTOIA 2005, s 691, ex TA 1988, s 325) was repealed by FA 2011.

[4] ITTOIA 2005, Pt 6, Ch 4, ss 702–708, ex TA 1988, s 326 and Sch 15A (not relevant for corporation tax).

[5] ITTOIA 2005, s 703 refers to ITEPA 2003, s 516(4).

[6] TCGA 1992, s 115.

[7] ITTOIA 2005 generalised the PEP regulation-making powers in TA 1988, ss 333 *et seq* and repealed the TESSA regulation-making powers in TA 1988, ss 326A *et seq* (added by FA 1990, s 28)—not relevant for corporation tax.

(6) Income and capital gains from funds invested with a venture capital trust,[8] enterprise investment scheme, seed enterprise investment scheme, corporate venturing scheme, social investment or real estate investment trust (REIT).
(7) Pension funds (chapter eighty below).
(8) Unit trusts, etc (see §79.4 below).
(9) Securities which are free of tax to residents abroad (FOTRA) securities.[9]

Other tax privileges include the following:

(10) Tax deductions for investments by an individual in shares in certain qualifying trading companies under the venture capital trusts, enterprise investment scheme, and seed enterprise investment schemes.
(11) An individual's contribution to a pension scheme is deductible from income, for income tax purposes, within limits: see chapter eighty below.
(12) CGT exemptions and deferrals of gain if reinvested (see CGT chapters above and especially chapter thirty-two).
(13) The first £2,000 of dividends earned by an individual are tax-free by virtue of the Dividend Allowance, with excess dividends taxed at more favourable rates than other forms of income.

78.3 Individual Savings Accounts[10]

As from 6 April 1999 the former favoured savings devices of tax exempt special savings accounts (TESSAs) and personal equity plans (PEPs) ceased to be available for new investment. They were succeeded by individual savings accounts (ISAs). On 1 July 2014 ISAs were reformed and rebadged as 'New ISAs' (NISAs); since most financial institutions and the public still use the term ISA that term is retained in this book. Unlike the predecessor schemes, the ISA includes a number of voluntary standards designed to make some schemes attractive to savers as distinct from fund managers; these are the 'CAT standards', which set levels for charges, access and terms.[11] There was much delight in certain circles when ISAs had a slow start; since investors had just rushed to save with TESSAs and PEPs for the last time, some savings fatigue was not surprising. Later figures suggested that ISAs became quite popular.[12] For many taxpayers, however, the combination of the Dividend Allowance and the PSA has greatly reduced the benefits of ISAs—especially in a low interest rate environment.

[8] ITTOIA 2005, Pt 6, Ch 5, ss 709–712.
[9] ITTOIA 2005, Pt 6, Ch 6, ss 713–716, FA 1996, s 154 (still in force for corporation tax).
[10] Regulations were made under FA 1998, s 75, which refers to TA 1988, ss 333 and 333B, TCGA 1992, s 151. The principal regulations are the Individual Savings Account Regulations 1998 (SI 1998/1870) (hereafter 'ISA Regs'), [1998] *Simon's Weekly Tax Intelligence* 1200; and the Individual Savings Account (Amendment) Regulations 1999 (SI 1998/3174), [1999] *Simon's Weekly Tax Intelligence* 97. See also Inland Revenue Press Release, 1 April 1999, [1999] *Simon's Weekly Tax Intelligence* 730.
[11] See Treasury Press Release, 22 December 1998, [1999] *Simon's Weekly Tax Intelligence* 32.
[12] Chennells, Dilnot and Emmerson (eds), *Green Budget 2000* (Institute for Fiscal Studies, 2000), 78.

An ISA is a scheme of investment which may be used by a qualifying individual[13] aged 18 or over and resident in the UK.[14] For many years ISAs had maxi accounts and mini accounts. Currently ISAs are divided into two types: (1) stocks and shares ISAs, and (2) cash ISAs. Savers can make contributions into one of each type of ISA per tax year. The overall maximum ISA subscription level per tax year is £20,000 (for 2021–22), and savers can invest this entire amount in cash ISAs or stocks and shares ISAs or a combination. From 2011, Junior ISAs are available for children aged under 18, with a maximum subscription limit of £9,000 (for 2021–22). Junior ISAs replaced an earlier investment product called Child Trust Funds. From April 2015 existing Child Trust Funds can be transferred into Junior ISAs. Junior ISAs remain tax-free until the child turns 18, at which point it is converted into a normal ISA.

Like TESSAs and PEPs, ISAs allows individuals to hold various investments free of income tax and CGT.[15] Unlike those schemes, ISAs allow investors to use an insurance policy. An ISA, by abolishing the PEP distinction between qualifying and non-qualifying funds, has a slightly wider geographical spread than a PEP, and permits investments in gilts. Like a PEP, but unlike a TESSA, an ISA has no lock-in period to qualify for tax relief. An ISA may be opened by someone on behalf of the qualifying individual and does not have to be opened in writing.

A ‘help-to-buy' ISA was introduced in 2015 to assist first-time homebuyers.[16] The government provides a cash bonus of 25% of amounts saved. The maximum government bonus is £3,000 per person (£6,000 if a couple). From April 2017, a more flexible Lifetime ISA allows individuals aged 18–40 to save up to £4,000 per annum plus receive a government bonus of 25% of the amount saved. The Lifetime ISA can be used to buy a first home or withdrawn after the age of 60. Earlier withdrawals can be made but with a penalty. Those with help-to-buy ISAs are able to transfer them into the Lifetime ISA. Amounts saved in Lifetime ISAs count towards the £20,000 annual ISA limit.

78.4 Purchased Annuities

There are several types of purchased life annuity, which may be immediate or deferred and may be for life or for a period of years (or a mixture with life but a guaranteed five-year period). Their attraction is that they are an insurance against outliving capital. Their weakness, apart from the risk that the annuitant dies the day after the purchase without any minimum period of payment, is that they will either be eroded by inflation or, if proofed against inflation, will be lower than the purchaser may expect.

78.4.1 Theory and Avoidance

The investment of one's capital in the purchase of an annuity meant that one was buying income with capital and that income tax was therefore due on the whole of each payment

[13] ISA Regs 1998, reg 4(1).
[14] ISA Regs 1998, reg 10; Crown employees within TA 1988, s 132(4)(a) also qualify.
[15] ISA Regs 1998, reg 22.
[16] See https://www.helptobuy.gov.uk/help-to-buy-isa/how-does-it-work/.

received, even though, in commercial reality, one was receiving back each year a part of one's capital together with interest. A number of ways around this all-income treatment were devised. The first, which lasted until 1949, provided for an advance by way of interest-free loan each month, which was to be extinguished by set-off against a capital sum due under the contract on death. The Revenue's argument that these were in substance annual payments was rejected.[17] Such loans are now treated as income. A second way, which still survives, applies to an annuity certain, ie an annuity payable for a stated number of years, not depending on the survival of the annuitant. The Court of Appeal held that tax was chargeable only on so much of the payment as represented interest and not on the whole sum.[18] This split treatment was not accorded to normal annuities, which terminated on the death of the annuitant, and so companies would issue 'split annuities', meaning an annuity certain for a stated number of years, to be followed by a deferred annuity. The payments under the former annuity would be divided into capital and interest. While the latter would be taxable in full, it was arranged that the sum payable under the contract would be higher and, in any case, the cost of it would be lower in view of the more advanced age of the annuitant.

78.4.2 Current Law—Splitting

The premise that a purchased life annuity is taxed in full is maintained by the charging rule in ITTOIA 2005, Part 4, Chapter 7. This is, however, subject to the partial exemption in Part 6, Chapter 7, which allows splitting and has been part of the law since 1956. Only those who love the Rewrite can understand why these two batches of provisions, consisting of five and eight sections, are separated in this way. The statute includes procedural rules, eg on claims and appeals, and a regulation-making power.[19] The rules in TA 1988, sections 657 *et seq* that formerly applied for corporation tax were repealed by FA 2008 when life insurance contracts were brought into the loan relationship rules. The relevant legislation is now in CTA 2009, Part 6, Chapter 11, sections 560–569. The discussion below focuses on the income tax treatment.

Under the splitting procedure, that part which represents the estimated capital content is exempt from tax and only the balance is income. This approach does not apply where the annuity is already given some relief or is not purchased by the annuitant. An annuity is not split if, apart from Part 6, Chapter 6, it is treated as having a capital element, or if the premiums have qualified for life insurance premium tax relief.[20] Also taxable in full are annuities purchased or provided for under a will or settlement, out of income of property disposed of by the will or settlement (whether with or without resort to capital).[21] Annuities provided under schemes such as those for retirement benefits or personal pensions—under which the contributors have already received tax reliefs—are also outside the apportionment rules, but this is because of the provisions in ITEPA 2003, Part 9 (pension income)

[17] *IRC v Wesleyan and General Assurance Society* (1946) 30 TC 11.

[18] *Perrin v Dickson* [1930] 1 KB 107, (1930) 14 TC 608; but doubted in *Southern-Smith v Clancey* [1941] 1 All ER 111, (1941) 24 TC 1.

[19] ITTOIA 2005, ss 717, 723 and 724.

[20] ITTOIA 2005, s 718 (2)(a), ex TA 1988, s 657(2).

[21] ITTOIA 2005, ss 718 (2)(b) and (c).

which have priority.[22] Apportionments are made if the sums paid are partly for the annuity and partly for other reasons.[23]

The method of apportionment between income and capital—or, as ITTOIA 2005, now puts it, between income and the exempt amount—is carried out by dividing the sum spent by the normal expectation of life according to government mortality tables, regardless of the individual.[24] The rules contain two variables, thus creating four situations. The first variable is whether or not the amount of the annuity depends solely on the duration of a human life or lives;[25] the second variable is whether the term of the annuity depends solely on the duration of a human life or lives.[26] The four situations are:

— Situation 1: where the amount of the annuity payments depends solely on the duration of a human life or lives. Here the statutes direct how one calculates the exempt proportion.[27]
— Situation 2: where the amount also depends on another contingency. Here each payment is exempt only in so far as it does not exceed a fixed sum; shortfalls in payments may be carried over to other years.[28]
— Situation 3; where the term depends solely on the duration of human life or lives. Here the exempt proportion and the exempt sums are calculated under rules in sections 720 and 721.[29]
— Situation 4: where the term of the annuity depends on other factors too. Here the rules in sections 720 and 721 are applied, and a just and reasonable apportionment is made.[30]

If one spouse, H, transfers an annuity to the other spouse, W, with whom H is living, the transfer will be ineffective for tax purposes since the transfer is of a right to income and so the settlement rules discussed above in chapter thirty-one will apply.[31] If the annuitant cashes in the policy, the same charge to tax may arise as under the chargeable event rules.

The calculation of the taxable income element and the tax-free capital element used to be done by HMRC. This is not really appropriate in the days of self-assessment, and so FA 2007, section 46 amended TA 1988, sections 656 and 658, and ITTOIA 2005, sections 717 and 623 remove this HMRC role.

[22] ITTOIA 2005, Pt 4, Ch 1, s 366 and explanatory notes. The same goes for a sum taxable in full under Pt 2 or Pt 10.
[23] ITTOIA 2005, s 722.
[24] The tables are authorised under ITTOIA 2005, s 724, ex TA 1988, s 658; the manner of computing them was put under statutory authority only in 1991 (with retroactive effect) (FA 1991, s 76). The tables must be obeyed (*Rose v Trigg* (1963) 41 TC 365). This is hard, since a person with lower-than-average life expectancy may get special terms from a company.
[25] ITTOIA 2005, s 719(2)–(5).
[26] ITTOIA 2005, ss 719(2) and (6)–(8).
[27] ITTOIA 2005, s 719(3).
[28] ITTOIA 2005, ss 719(4) and (5).
[29] ITTOIA 2005, ss 719(6) and (7).
[30] ITTOIA 2005, s 719(8).
[31] ITTOIA 2005, s 625(3), ex TA 1988, s 660A(6).