



# Investment trust tax advantages

The purpose of this factsheet is to bring to investors' attention the various tax advantages of investment trusts (ITs).

There are many investment advantages in buying shares in ITs. These are fully explored in other AITC factsheets. It should be stressed that any investment decision must be based on the merits of the particular investment itself and the investor's attitude towards risk.

The tax advantages of ITs are important and a thorough understanding of them will help investors to maximise the returns from ITs by reducing the potential tax liabilities thereon.

The first important point to note is that ITs are exempt from tax on their capital gains. In other words, any capital gains that the IT makes from buying and selling its investments will not be subject to tax. The significance of this cannot be overstated. An IT invests in the shares of other companies. In many cases the object of this investment is capital gain.

ITs are subject to corporation tax on some sources of income (as distinct from tax on capital gains) that they receive from their investments - interest on bond investments and overseas dividends for example. One important exception is that they are, however, like all companies exempt from tax on the dividends they receive from UK companies.

In theory, an IT could pay tax on its other forms of income, such as bond interest and overseas dividends, at anything up to 30%. However, an IT is allowed to offset most of its expenses (e.g. its management fee, interest paid on gearing etc.) against such income to reduce its corporation tax liability.

An IT can also obtain relief for overseas tax incurred on overseas investments, known as withholding tax. Withholding tax is deducted from overseas dividends before they are paid. The level of withholding tax varies between countries but it can be significantly reduced where a double tax treaty has been concluded between the paying and recipient countries. The UK has a large number of double tax treaties in place.

As a result, ITs rarely pay any corporation tax on their investment income, making them highly tax efficient vehicles. Indeed a manager may even deliberately invest in investments which generate taxable income in the knowledge that this will be offset by the expenses of running the trust.

When the investment advantages of ITs are considered in the light of the tax concessions available, the case in their favour is a powerful one.

## THE PRIVATE INVESTOR

The tax year runs from 6 April until the following 5 April. On the income tax front, the tax rate payable depends upon the type of income - earned income, savings such as bank and building society deposit account interest, and dividends.

Each individual has a personal allowance and if all income falls within this, no income tax is payable. The allowance for the year 2002/03 is £4,615. This increases to £6,100 for those aged 65-74 and £6,370 for those aged 75 and over.

These higher allowances for those aged 65 and over are subject to an income limit and are progressively reduced back to the basic allowance when annual income exceeds £17,900. After deducting the personal allowance, the next band of income, regardless of its source, is taxed at the lower rate of 10%. In 2002/03, the first £1,920 above the personal allowance qualifies for this lower rate.

From this point onwards the tax treatment of income varies. As far as dividend income is concerned, UK dividends carry a tax credit which satisfies any tax liability for a lower and basic rate taxpayer. Note that non-taxpayers cannot claim repayment of the tax credits on their dividends unless they are holding them in an ISA (and ISA repayment will cease on 5 April 2004).

However, the rate payable for a higher rate taxpayer is 32.5% on the total of the dividend and the tax credit, with relief then being given for the tax credit. What this means in practice is that a higher rate taxpayer has to pay over to the Inland Revenue 25% of the dividend received.



## LOSSES

Before losses are set off against capital gains, the gain is first subject to frozen indexation. This is only applicable if the asset was purchased before 1 April 1998. Next, any allowable losses are deducted from the gain and then taper relief is applied to that net amount. Losses can be set against chargeable gains in an order that gives the taxpayer the greatest benefit from taper relief, thus resulting in the lowest amount chargeable to CGT. In other words, losses should first be set against gains which qualify for the least taper relief.

Allowable losses realised in the current tax year must be set against gains, even if this reduces them below the amount of the exemption (£7,700 in 2002/03). Losses brought forward need only be utilised to reduce the net gain, before taper relief, to the amount of the exemption. The balance of any losses can be carried forward.

Losses need careful management, particularly as time goes on and the level of taper relief rises to 40%. Being forced to use losses to reduce gains down to the level of or below the exempt amount means that taper relief is being foregone at the expense of losses.

To learn more about investment trusts and how they can help you make the most of your savings please call us free on **0800 707 707** or visit our website at **[www.itsonline.co.uk](http://www.itsonline.co.uk)** for further information.

## CAPITAL GAINS TAX (CGT)

CGT relates to capital appreciation of assets as distinct from any income deriving from them. Until 31 March 1982, any gain or loss was simply computed by taking the difference between purchase and sale price. An indexation allowance has been given since March 1982, whereby the purchase price of an asset can be adjusted to remove any inflationary element from the gain. The cost of an asset acquired before 31 March 1982 is taken to be its value on that date, although original cost can be used in some circumstances.

For assets acquired on or after 1 April 1998, individuals will receive no indexation allowance. Instead, any gain will be subject to taper relief. For assets purchased before 1 April 1998, the purchase price can still be indexed up to 31 March 1998 - this is known as frozen indexation.

Gains and losses are aggregated to give net chargeable gains or allowable losses for the year. If losses exceed gains they can be carried forward without limit to set against future gains.

Taper relief reduces the proportion of a chargeable gain brought into charge to tax according to the number of whole years, up to a maximum of 10, that it has been held. Fractions of a year are ignored. Once an asset has been held for three full years from 6 April 1998, any chargeable gain can be reduced by 5%. A further 5% reduction applies for each full year after three that the asset is held. The maximum reduction is 40% once an asset has been held for 10 years or more. For assets acquired on or before 17 March 1998, a bonus year's relief will be given, but the maximum is still 10.

Please note that there is a more generous rate of taper relief for business assets which is outside the scope of this guide.

### Taper Relief - Non-business Assets

Number of whole years in holding period	Percentage of gain chargeable
Less than 1 year	100
1	100
2	100
3	95
4	90
5	85
6	80
7	75
8	70
9	65
10 or more	60

Each individual has an annual exempt amount and the first £7,700, in the 2002/03 tax year, of total gains are tax-free. Thereafter, net chargeable gains are added to an individual's income and taxed at either 10%, 20% or 40% according to whether they fall into the lower, basic or higher rate band respectively. Note that shares must be held for a complete year to qualify for taper relief - two years three hundred and sixty four days only counts as two years. Note also that shares acquired after 5 April 1998 are assumed to be disposed of on a last in, first out basis. In addition, such shares will always be treated as if sold before any that were acquired up to 5 April 1998.

This is particularly relevant when dealing with gains arising from an IT savings scheme. Investors need to draw up a table showing the exact date of each purchase, the number of shares purchased and their cost. When some shares are sold, a separate taper relief calculation will need to be done for each separate purchase that makes up the total sold, starting with the most recent purchase and working backwards until the total sold has been accounted for. There is an AITC factsheet which deals with savings schemes at length (for shares acquired after 6 April 1999) which can be found at [www.itsonline.co.uk/technical](http://www.itsonline.co.uk/technical). Further information on CGT and savings schemes can also be found at [www.inlandrevenue.gov.uk/leaflets](http://www.inlandrevenue.gov.uk/leaflets).

## TAX ADVANTAGES OF INVESTMENT TRUSTS

How can investors use ITs to apply these rules on income tax and CGT to their advantage? There are two main areas:

- The first concerns those individuals who are not in receipt of sufficient income to utilise their personal income tax allowance or lower-rate band of 10% - as we have seen, a total of some £6,535 to £8,290 in the tax year 2002/03, depending on age.
- The second concerns those who are not taking advantage of their annual exempt amount for the first £7,700 capital gains in the tax year 2002/03.

A special type of IT, called a split capital IT, enables investors to focus on either income or capital gain. In summary, they have different classes of shares with differing rights attached. They generally have a fixed date when they will be wound up and all the assets distributed (their life, however, can be extended if the shareholders agree). In its simplest form there will be two types of shares - income and capital.

Income shareholders will receive all the income generated and none of the capital growth, and vice versa for the capital shareholders. There is now, however, often a preferential type of share known as a Zero Dividend Preference Share (Zeros). Zeros aim to pay out a pre-determined capital sum. They can be a lower risk type of share since zero shareholders are paid out before any other shareholders (but after any bank debt has been repaid). However, the pre-determined capital sum is not guaranteed and is dependent on there being sufficient assets available.

Split capital ITs may also have income and residual capital shares. These are hybrids since they offer both higher levels of income and the prospect of capital growth. Less common are annuity shares which offer a high level of income but return virtually no capital at all to their shareholders when the trust is wound up.

Thus, split capital trusts can be used effectively to give up income in exchange for capital growth or vice versa. Essentially, in the simplest case, one group of shareholders takes all the income and the other takes all the capital growth.

Thus, those not using their income tax allowance might consider income shares or annuity shares, and those not using their capital gains tax allowance might consider zeros or capital shares. If additional income is required by those not using their capital gains tax allowance, periodic sales of zeros or capital shares will effectively provide a tax-free income up to the limit of the annual exempt amount (unused) each year. It must be noted that the returns from the shares of a split capital investment trust are not guaranteed and that the value of the shares and the income from them can go down as well as up.

## OWNING INVESTMENT TRUST SHARES

### For further information...

#### Visit our website

Our website is a good place to start if you want to learn more about investment trusts and how they can help you get the most from your savings. You can find us at [www.itsonline.co.uk](http://www.itsonline.co.uk)

#### Contact an Independent Financial Adviser

If you would like any further information or advice, you should contact an Independent Financial Adviser (IFA). You can get the details of three IFAs in your area by calling 0800 707 707.

### Look out for this symbol



Investment trusts regularly advertise in the national and financial press - just keep your eyes open for the symbol above.

### Information factsheets

The AITC publishes a range of factsheets which are available free of charge by calling 0800 707 707.

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