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The Investor's Tax Bible

How to Slash Your Taxes When You Trade or Invest in Shares, Bonds, Options & CFDs

By Lee Hadnum LLB ACA CTA

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TAX GUIDE - "The Investor's Tax Bible: How to Slash Your Taxes When You Trade or Invest in Shares, Bonds, Options & CFDs"

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67 Milton Road
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Tel: (0044) 01592 560081
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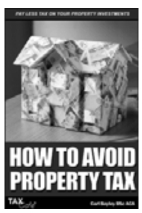

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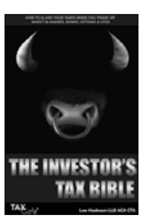

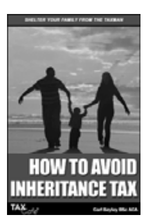

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Introduction

This guide takes an in-depth look at how tax affects stock market traders and investors. The focus throughout is on translating complex tax concepts into plain English and providing guidance, wherever possible, on how to cut your tax bill.

The guide contains numerous examples to illustrate every key point. There is also a tremendous amount of unique 'number crunching', which provides fascinating results and will help you pay less tax.

Turning to the individual chapters, in Chapter 1 we summarise all the taxes you face as a stock market investor and pinpoint which ones are the most important. Chapter 2 illustrates good versus bad tax planning and why trying to save tax should never be your main priority.

The main focus of this guide is capital gains tax because this is the tax that affects investors most... and offers the most scope for constructive tax planning. In Chapter 3 we provide a quick introduction to how capital gains tax is calculated.

In Chapter 4 we take a more detailed look at each component of the capital gains tax calculation: Proceeds, acquisition cost, the complex share matching rules, what expenditure you can and cannot deduct, tax reliefs and the annual capital gains tax exemption. We then examine how the final tax bill is calculated.

Chapter 5 briefly explains the old rules for disposals prior to 6 April 2008.

In the next three chapters we examine some specific cases. In Chapter 6 we explain how unit trust and other fund investors calculate capital gains tax and some of the special tax rules that apply to these investments.

Chapter 7 takes a closer look at calculating tax on rights issues and takeovers and Chapter 8 shows how gains from options and warrants are taxed, as well as taking a quick look at CFDs.

Once you've calculated your capital gains tax you may have to complete the special CGT pages of your tax return. Chapter 9 explains when and how to do this.

The next 10 chapters cover capital gains tax planning: In Chapter 10 you'll learn how to make the most of your annual exemption by making frequent share disposals, Chapter 11 shows how married couples can split their gains and achieve a lower tax bill, and Chapter 12 looks at how assets can be gifted to children so that they can make use of their annual CGT exemptions.

In Chapter 13 we then explain what strategies you should follow to make the most of your losses, Chapter 14 explains the tax benefits of ISAs and how you should use them to obtain the maximum tax relief, and Chapter 15 covers spread betting and compares this activity with normal share trading.

Chapter 16 looks at why unit trusts are a fantastic tax shelter for investors who have already made use of their annual capital gains tax exemptions, and Chapter 17 covers the two main tax shelters available to UK share investors: venture capital trusts and enterprise investment schemes.

Chapter 18 takes an in-depth look at the tax benefits of investing in equities compared with property and finally in Chapter 19 we look at non-resident and offshore tax planning.

In Chapter 20 the focus changes to gilts and corporate bonds and we examine their place in your investment portfolio and *how* you should invest in these important assets to ensure that your after-tax returns are beating inflation.

In Chapter 21 we examine the income tax treatment of dividends and how they compare with income from other investments. We also look at ways married couples can split their income... and all the traps to avoid.

Chapter 22 looks at some recent tax changes, including the 50% additional tax rate, the withdrawal of personal allowances for those earning over £100,000 and the new 28% capital gains tax rate.

Chapter 23 is all about inheritance tax and how this impacts on stock market investing and the kind of planning you can undertake to minimise the eventual tax bill.

Many share investors ask whether it is better to be taxed as a 'trader' or an 'investor'. Chapter 24 answers this question pretty definitively.

Chapter 25 weighs up all the tax benefits and drawbacks of setting up your own company to trade in shares.

Finally, Chapter 26 explains how share clubs are taxed.

Throughout the guide we use examples and some of them relate to tax years. Remember the tax year always starts on April 6th and ends the next year on April 5th. We also use a number of abbreviations, the most common ones being CGT (capital gains tax), IHT (inheritance tax) and HMRC (HM Revenue and Customs).

You will also notice that we often talk about 'share investors' when in fact we are referring to 'financial asset investors', which doesn't have quite the same ring to it! The latter includes bond investors, unit trust investors etc. There are specific tax rules that relate to these investments and which we highlight but much of the guide applies to all financial assets, not just shares.

Finally, remember there is a BIG difference between what stock market enthusiasts mean by the terms 'share trader' and 'share investor' and what the taxman takes these words to mean. The taxman has a number of guidelines as to what constitutes trading and investment, the latter being subject to capital gains tax, the former being subject to income tax. Even very active buyers and sellers of financial assets are usually 'investors' in the taxman's eyes and subject to capital gains tax. In Chapter 24 all of this will be explained.

Chapter 1

What Taxes Do Stock Market Investors Pay?

There are a whole variety of taxes that you could end up paying if you are a share trader or investor. The most important ones are:

Income Tax

Individuals pay income tax on any income they receive from shares or other securities.

How much tax you pay depends on how much income you earn during the tax year:

- Interest is taxed at 10%, 20%, 40% or 50%.
- Dividends are taxed at 10%, 32.5% or 42.5%, although the 'effective' tax rates will be 0%, 25% or 36.1%.

In addition, it should be noted that any trading income is subject to income tax, although it would be taxed at 20%, 40% or 50%.

In most cases profits made from selling shares are subject to capital gains tax. However, if the taxman classes you as a share trader your profits will be taxed as income.

Chapter 24 examines in detail the tax implications of being classified as a share trader.

Capital Gains Tax (CGT)

For most investors this is the most important tax to consider and it is examined in considerable detail throughout this guide.

Capital gains tax is usually payable on any profit you make when you sell an asset. More precisely, tax is payable on the 'chargeable gain', which is the amount left over after you have deducted a variety of reliefs and allowances.

The CGT rate for disposals after 5th April 2008 was fixed at 18%. In the emergency Budget on 22nd June 2010 a new 28% CGT rate was introduced. This new rate is payable by higher-rate taxpayers who sell assets after 22nd June 2010.

Despite this increase in CGT, you are usually much better off paying capital gains tax instead of income tax. For most higher-rate taxpayers there is a 12% tax saving. Those who earn over £150,000 pay income tax at 50% and enjoy a 22% tax saving!

Not only is capital gains tax levied at a lower rate than income tax, it also offers more opportunities for constructive tax planning.

Stamp Duty

Individuals and companies have to pay stamp duty when they buy most shares or other securities.

The rate for shares is fixed at 0.5%.

There's not much you can do to avoid stamp duty (except join the campaign to have it abolished!). However, share investors are often much luckier than property investors who often end up paying between 3% and 5% on their investments.

Corporation Tax

A UK resident company pays corporation tax on its worldwide income, profits and gains. It does not pay income tax or capital gains tax.

To calculate a company's tax bill, its total income and capital gains are simply added together and subjected to corporation tax.

The effective rates of corporation tax vary from 20% to 27.5%, depending on the level of the company's profits.

The reason we mention this tax here is that, in Chapter 25, we will be taking a detailed look at the pros and cons of starting your own company to trade shares.

Inheritance Tax (IHT)

Any shares owned at the date of an individual's death will ordinarily be included within the estate for inheritance tax purposes, although there are certain reliefs available.

Where it applies, IHT is charged at 40% on the value of the estate exceeding the nil rate band (currently £325,000).

There are special provisions for transfers of shares (or other assets) to trusts or companies in which case an immediate inheritance tax charge can arise, irrespective of the fact that the person making the gift has not yet died.

Companies aren't liable for inheritance tax although in exceptional circumstances certain dealings by companies can result in shareholders paying tax. Inheritance tax is covered in greater detail in Chapter 23.

National Insurance

National insurance would only be relevant if:

- You take on an employee to assist you in your share dealing activities. In this case, class 1 primary and secondary contributions would be payable (by the employee and the employer).

- You are classed as a share trader. In this case class 2 and 4 contributions would be payable by you, as with any self-employed individual.

- You establish a company and decide to pay yourself a salary. In this case class 1 contributions have to be paid.

National insurance is covered in more detail in chapters 24 and 25, where we take a detailed look at share trading and the pros and cons of using a company. For the vast majority of share investors national insurance is not an issue.

Value Added Tax (VAT)

Almost every share investor or trader will end up paying VAT, for example when you pay for software, website subscriptions or other electronic information. For example, if you bought the electronic version of this tax guide from our website you will have paid VAT! However, if you bought the printed edition you will not have paid any VAT because printed books are 'zero-rated'.

In the vast majority of cases there is nothing you can do about VAT. In the unlikely event that you are VAT registered the tax you pay can be recovered in full.

Summary

As a share investor or trader you are likely to pay a wide variety of taxes: income tax, capital gains tax, stamp duty, VAT and inheritance tax.

The most important tax, without doubt, is capital gains tax. If gains on disposal are large your tax bill could also represent a significant sum. However, as we will see, there is plenty you can do about it.

Chapter 2

Good vs Bad Tax Planning

The primary aim of anyone buying or selling shares or other securities is to make money. This may sound obvious but many assets such as property, classic cars, rare stamps and fine art, are often also bought for pleasure.

With shares it's much more cut and dried. Most serious investors enjoy researching what companies to buy and tracking their progress. Ultimately, however, the real buzz comes from making a profit.

Because making money is the only thing that counts and when you consider that, in the worst case scenario, you could be losing 28% of your profits to the taxman, tax planning should always feature high on your agenda.

Take the example of Warren and Gordon. Let's say Warren buys some shares for £5,000 and sells them for £15,000 but ends up paying 28% tax. He will end up with £12,200.

If Gordon only manages to sell his shares for £14,750 but, through careful planning, ends up paying tax at an effective rate of 10%, he will end up with £13,775. Warren may be a better stock picker but Gordon is surely the better investor.

This example is simplistic but the point is clear. Good tax planning can have a significant effect on your after-tax returns.

The critical point is this:

It's not big profits you're after but big *after-tax profits*.

While tax planning is a critical part of the process, there is good tax planning and bad tax planning. Saving tax should never be you primary consideration. If it were, everyone would invest solely in venture capital trusts. These are possibly the best tax shelters available but unfortunately they're also incredibly risky.

What's so great about paying zero per cent tax on your profits if you have no profits in the first place? We call this spending £1 to save 28p in tax.

Here are some typical examples of BAD tax planning:

- Using up your annual ISA allowance even though you're not confident shares will do well this year.

- Postponing a sale of shares until the new tax year, only to find the markets plummeting in early April.

- Selling shares to make use of your annual capital gains tax exemption only to see them soar in value before you've had a chance to reinvest.

- Investing in a venture capital trust to make use of the generous income tax relief, only to find that the shares in the fund fall by more than 30% before you're legally allowed to sell them.

- If you're not domiciled in the UK, investing in US shares because the profits will not be immediately taxed in the UK, only to find that the US market underperforms the UK market.

- Topping up your pension contributions, only to find that you need the cash to pay your children's school fees.

- Becoming taxed as a share trader so that you can claim extra tax deductions, only to find that your expenses do not exceed your forfeited annual capital gains tax exemption.

- Reinvesting all your profits after the end of the tax year, even though some may be owing to the taxman.

- And, worst of all, gifting assets to your spouse who later on runs off to Barbados with your stockbroker!

In each case the investor has his eye on saving tax instead of maximising his total after-tax profits.

Throughout this guide our focus will be on realistic tax saving strategies that do not jeopardise the primary objective: to make successful investments!