

HOW TO MAXIMISE YOUR TAX-FREE INTEREST



TAX-FREE CASH



Taxcafe Tax Guides

Tax-Free Cash

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Dr Nick Braun founded Taxcafe in 1999, along with his partner Aileen Smith. As the driving force behind the company, their aim is to provide affordable plain-English tax information for private individuals, business owners and professional advisors.

Since then Taxcafe has become one of the best-known tax publishers in the UK and has won several prestigious business awards.

Nick has been a specialist tax writer since 1989, first in South Africa, where he edited the monthly *Tax Breaks* publication, and since 1999 in the UK, where he has authored several tax books including *Pension Magic*, *Small Business Tax Saving Tactics* and *Salary versus Dividends*.

Nick also has a PhD in economics from the University of Glasgow, where he was awarded the prestigious William Glen scholarship and later became a Research Fellow.

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Introduction

Between 2009 and 2022 the UK enjoyed well over a decade of rock-bottom interest rates.

Rates were first cut aggressively in the aftermath of the 2008 global financial crisis and reached their lowest level in March 2020, during the coronavirus pandemic, when the Bank of England cut its base rate to just 0.1%.

A similar picture could be seen all around the world. Some commentators pointed out that interest rates hadn't been this low in 5,000 years.

Throughout this period mortgages were dirt cheap, providing a huge boon to homeowners and landlords. At one point it was possible to fix your mortgage at less than 1% for five years.

Savers were not so lucky. Most easy-access accounts paid minuscule amounts of interest, often no more than 0.1% per year. Many people simply left all their cash in a current account earning no interest at all – there was very little incentive to do anything else.

This has all changed. The era of ultra-low interest rates is now over and savers and borrowers have to change their behaviour to make the most of the new state of affairs.

That's what this brand new guide is all about. In the pages that follow you will discover how to earn more interest on your cash and how to make sure your interest is always ***tax free***.

Part 1 Interest Rate Basics

Chapter 1 looks at the importance of *real* (inflation-adjusted) interest rates. If you can earn a real return on your savings, your wealth will increase over time.

But to earn that precious real return you may have to shop around for the best deals AND your interest income will probably have to be tax free.

To enjoy the highest interest rates you may have to place your savings in some of the smaller, lesser-known banks. Fortunately the Financial Services Compensation Scheme (FSCS) shoulders all the risk – up to £85,000 per person per banking group.

Chapter 2 tells you everything you need to know about this compensation scheme: how company owners and other business owners are protected, how cash held in your SIPP or stocks and shares ISA is protected, how to avoid banks that share the same banking licence and the special protection for “temporary high balances” of up to £1 million.

Chapter 3 explains how the “annual equivalent rates” (AERs) you see advertised with various savings products are calculated and how to use them to maximise your interest income.

Part 2 How Interest Income Is Taxed

Chapter 4 covers the personal savings allowance and starting-rate band. These allow you to earn anything from £500 to £6,000 of tax-free interest when your savings are not sheltered in an ISA.

Chapter 5 shows how much income tax is payable by those who have used up their various tax-free allowances and what can be done to reduce the amount of tax payable on interest income.

Chapter 6 explains ***when*** your interest income will be taxed. With some savings accounts interest is only taxable when the product matures – possibly after five years. In one example we show how, by postponing tax, the taxpayer ends up £1,469 better off; in another example the taxpayer ends up £737 worse off.

If you are a company owner you may be able to enjoy an additional £5,000 of tax-free interest. However, your interest income may also increase the tax payable on your dividend income. Chapter 7 has several examples showing how much tax different company owners pay on their interest income.

Part 3 Making the Most of Tax-Free ISAs

We all know about ISAs but this part of the guide contains lots of unique information that will help you make the most of this wonderful tax shelter.

Chapter 8 looks at cash ISAs: how to find the highest interest rates, a recent change that has made cash ISAs much more attractive, the tremendous benefits of Flexible ISAs (not all banks offer them) and how to transfer your existing ISA savings to take advantage of the best deals.

Chapter 9 covers money market funds. These have attracted billions of pounds of investors' cash in recent times. Money market funds pay more interest than most banks (around 5.3% at present), all tax free if held in a stocks and shares ISA. However, they're also a bit more risky than conventional savings products.

In Chapter 10 we discuss whether it's better to use your £20,000 ISA allowance to earn tax-free interest in a cash ISA or tax-free capital gains and dividends in a stocks and share ISA.

Chapter 11 examines the pros and cons of Innovative Finance ISAs. These offer the opportunity to earn much more tax-free interest (maybe 10% or more) but the risks are far greater.

Part 4 More Tax Planning Ideas

If you have to pay income tax on some of your interest income you can reduce the damage by making bigger pension contributions. Chapter 12 contains a number of examples showing how you can completely wipe out all the income tax payable on your interest income.

Chapter 13 explains how you can use your children to save tax. If you have to pay income tax on some of your interest income, one thing you can do is give money to your adult children so that they can earn tax-free interest. In one example this produces an overall saving of £2,340 after a few years.

Part 5 Savings Platforms & Premium Bonds

Chapter 14 shows how, by using an online savings platform like Hargreaves Lansdown's Active Savings, you can effortlessly transfer your savings from bank to bank, thereby maximising your interest income.

Chapter 15 is all about premium bonds, which allow you to earn tax-free prizes of up to £1 million. An investment in premium bonds can be an attractive alternative to a taxed savings account if you're a higher-rate taxpayer or additional-rate taxpayer.

Part 6 Sole Traders & Company Owners

In Chapter 16 we turn our focus to savings accounts available to sole traders and company owners. Why keep all your business cash in a current account when you can earn a decent amount of interest by opening an easy-access savings account? We also explain how company owners can get some of the company's cash into their own hands, so that they can earn tax-free interest.

Chapter 17 covers directors who *borrow* money from their companies and directors who *lend* money to their companies. A couple who run a company together can borrow up to £20,000 tax free for up to 21 months. Bigger loans can be made extremely cheaply.

And if you lend money to your company any interest the company pays to you could be both tax deductible for the company and tax free in your hands – the best case scenario when it comes to extracting cash from your company. Some company owners may be able to save over £1,000 by getting their companies to pay them interest.

Part 7 Earn Tax-Free Interest by Paying Off Debt

Paying off your personal debt is a great way to earn tax-free interest. This is because paying less interest is just as good as earning it – and often better from a tax standpoint.

Chapter 18 looks at the benefits and drawbacks of paying down the mortgage on your home. Apart from earning tax-free interest,

this may help you qualify for a better mortgage deal (by reducing the loan-to-value ratio on the property).

In Chapter 19 we compare paying down your mortgage with keeping money in a savings account. At present you may be able to enjoy a better tax-free return by keeping your money in a cash ISA... but paying off your mortgage may be more attractive than a taxed savings account.

Chapter 20 explains why paying off personal loans, credit cards and other short-term borrowings will often produce the highest returns of all. The average borrower will enjoy tax-free returns ranging from 9.05% to 22.45% per year.

In Chapters 21 and 22 we look at paying off buy-to-let mortgages and other business borrowings. As a general rule it's better to reduce your *personal* debt before you reduce your *business* debt – business debt enjoys tax relief and is therefore cheaper.

Landlords enjoy 20% tax relief on their interest payments and self-employed business owners who are higher-rate taxpayers enjoy 42% tax relief, sometimes as much as 62%.

However, sometimes these borrowers also face very high interest rates and loan arrangement fees. So these chapters show you how to quickly calculate the *after-tax* cost of your buy-to-let mortgages or other business borrowings.

Armed with this information you can decide whether it's worth using any spare cash you have to reduce these loans.

Company Owners with Business Premises

Many company owners own their business premises *personally* and the company pays them rent. There may also be a mortgage on the property and the interest payments will enjoy full tax relief, making this one of the best types of debt to have. Many company owners who are higher-rate taxpayers will be enjoying 45% tax relief on their interest payments.

Chapter 23 shows you how to quickly calculate the after-tax cost of such a mortgage, so you can decide whether it's worth paying off early.

Part 1

Interest Rate Basics

Chapter 1

The Importance of Real Interest Rates

Savings accounts and similar investments currently pay more interest than they have for well over a decade.

For example, instead of earning 0.1% in an easy-access savings account, interest rates of around 5% are available from some banks nowadays.

Does this mean savings accounts and the like are good investments? Not necessarily because we also have to look at how *inflation* erodes the value of your savings.

The only reason savings rates have gone up is because the Bank of England has increased its 'base rate' 14 times since December 2021. And the reason the central bank has increased interest rates is to get a grip on runaway inflation.

Higher interest rates reduce demand in the economy: people with mortgages have less to spend on other things, savers are happy keeping their cash in the bank and businesses are more reluctant to make investments using borrowed money. Lower demand for goods and services makes it harder for shopkeepers, landlords and suppliers to raise their prices.

At least that's the theory. In reality inflation is a complex beast and the Bank of England can only do so much without wrecking the economy.

Interest rate increases also take a long time to work their way through the system, often well over a year.

Inflation peaked at around 11% in October 2022, the highest rate since 1981. At the time of writing it had fallen to 4% which is encouraging but still some way from the Bank of England's 2% target.

Real versus Nominal Returns

To be a good or even acceptable long-term investment you have to be earning a *real* return on your savings.

In other words, your savings have to be rising in value faster than the prices of the goods and services you intend to buy with them.

For example, let's say you currently have £1,000 sitting in a savings account and use the money in 12 months' time to buy a variety of goods that currently cost £1,000.

If in a year's time your savings are worth £1,050 but the goods now cost £1,100 your savings will have lost some of their purchasing power. In other words, you will have become poorer. The *nominal* value of your savings may have risen but their *real* value has fallen.

For your savings to be rising in real terms the interest rate you are paid has to be higher than the inflation rate that is eroding them.

You can think of the real value of your savings as a bucket of water. Let's say the bucket is sitting underneath a slowly dripping tap. The dripping tap is the interest the bank pays you.

Let's also say the bucket has a small hole in the bottom which allows water to leak out. The hole is inflation.

If the water level in the bucket keeps rising, despite the hole in the bottom, this means your wealth is increasing in real terms, i.e. faster than inflation.

But if the water level is slowly falling, this means your wealth is falling in real terms – inflation is eroding their value faster than the bank is adding to them.

Calculating the Real Return on Your Savings

The real return is calculated by subtracting the inflation rate from the nominal interest rate.

For example, if you're earning 5% and the inflation rate is 4% you'll be earning a positive real return of 1%:

Nominal Interest Rate - Inflation Rate = Real Return

$$5\% - 4\% = 1\%$$

A positive real return is what you want because it means your wealth is actually increasing – maybe not by much but still increasing nevertheless.

But if you are earning a nominal interest rate of 1.75% (what my own bank is paying on its easy-access savings account) and prices are rising by 4%, you'll be earning a negative real return of 2.25%.

$$1.75\% - 4\% = -2.25\%$$

A negative real return means your wealth is falling.

Although a negative real return of 2.25% means you're only getting a little bit poorer each year, over long periods of time the erosion of your wealth is significant. After 10 years your savings will have lost around 20% of their purchasing power.

(Note the formula employed above to calculate real interest rates is just an approximation, although it's the one most journalists and commentators use. At the end of this chapter we will take a closer look at the correct formula.)

Real Returns and Tax

A major flaw in our tax system is you have to pay tax on nominal investment returns, not real returns. The Government forces you to pay tax on returns that are merely illusory.

For example, let's say you're earning 5% on your savings and have to pay 40% tax on this interest income. This means you'll be left with 3% after tax and your real return will fall to negative 1%:

$$3\% - 4\% \text{ inflation} = -1\%$$

After 10 years your savings will have lost around 10% of their purchasing power.

Are Savings Accounts Good Investments?

Those who shop around can find savings accounts paying somewhere between 5% and 5.5% interest at present (the rates vary between easy-access accounts and fixed-term accounts).

That's more than the current inflation rate, which at the time of writing was 4%.

It is therefore possible to earn a small positive real return on your savings... if we ignore any income tax that is payable.

If you have to pay 40% or 45% income tax on your interest income inflation will slowly erode the real value of your savings, even if you're shopping around for the savings accounts that pay the most interest.

Those who do not shop around will probably be earning a negative real return both before and after tax.

However, it's important to point out that the much publicised inflation number is backward looking, showing how prices have risen in the *previous* 12 months.

If you put your money in a fixed-rate account paying 5.25% over the next 12 months and inflation averages 2.5% during this period, you will enjoy a positive real return, even if you have to pay income tax at 45% on your interest income.

Of course none of us can predict what will happen to inflation over the next 12 months and it is perhaps wishful thinking to expect it to fall to 2.5%. Nevertheless it is worth pointing out that it is the *expected* inflation rate that matters, not the historical one.

It's also important to point out that everybody's inflation rate is different. The number reported in the media each month is based on a basket of goods and services called the Consumer Price Index or CPI.

If the basket of goods and services that *you* buy is different to this basket, your personal inflation rate will be higher or lower.

Research has shown that high income households are less affected by rising food prices, rents and fuel costs (the main contributors to inflation in recent times) than poorer households.

If you are a high income earner it's possible your personal inflation rate will be at least one percentage point lower than the published rate. In other words, you may be earning a modest real return on your savings, even though most people aren't!

In summary:

- Those who shop around for the best interest rates are probably earning a small positive real return (before tax) on their savings.
- Those who have to pay income tax at 40% or 45% on their interest income will probably be earning a negative real return, unless inflation falls in the months ahead.
- Those who do not shop around are very likely suffering negative real returns both before and after tax.

Thus the best savings accounts and other interest-earning investments are arguably acceptable long-term investments if you are an extremely risk-averse investor and do not have to pay income tax on your interest income.

(For some individuals, especially retirees, capital preservation is more important than capital gains and capital preservation is one thing savings accounts offer in spades.)

If you have to pay income tax on your interest income, savings accounts and other interest-earning investments are arguably unattractive long-term investments because your wealth will be slowly eroded by inflation.

However, this does not mean you should avoid them.

Savings accounts and other similar investments are a great place to temporarily store cash you intend to invest elsewhere when conditions are favourable.

They are also a great place to store money you may need in the near future because, unlike almost every other investment you can

make, the value of your savings generally cannot fall in nominal terms.

It's true the financial institution you entrust with your savings could go bankrupt. But there are safeguards in place such as the Financial Services Compensation Scheme, which protects £85,000 per person per banking group (see Chapter 2).

There are other interest-paying investments, like money market funds, that are a bit more risky (see Chapter 9). However, they are still extremely low-risk investments – much less risky than investing in equities or property.

Although savings accounts may not be viable long-term investments for many individuals, I have enormous sympathy for anyone who keeps all their money in the bank.

Those of us who have experience investing in the stock market know just how gut wrenching it is to watch share prices fall by 50% or more during a market crash. Investing is difficult!

If you do keep a significant amount of your wealth in savings accounts and similar investments it's important to:

- **Shop around for the best interest rates.** This wasn't as important a few years ago when almost all banks were paying paltry amounts of interest. There's a good chance the bank you use for your day to day banking is paying uncompetitive interest on savings. This is especially the case with easy-access savings accounts. As I pointed out earlier, my own bank is currently paying 1.75%, although rates of 5% or more are available elsewhere.
- **Earn tax-free interest** so that your savings have the best possible chance of keeping pace with inflation. Earning tax-free interest is what this guide is all about.

The Correct Way to Calculate Real Returns

Earlier in this chapter I stated that the real return on your savings is calculated as follows:

$$\text{Real Return} = \text{Nominal Interest Rate} \textit{ minus } \text{Inflation Rate}$$

For example, if you're earning 5% and inflation is 3% your real return is 2%.

However, as it turns out, the above equation is just an approximation.

The correct formula is called the "Fisher equation" (after the American economist Irving Fisher) and looks like this:

$$\text{Real Interest Rate} = \left[\frac{1 + \text{Nominal Interest Rate}}{1 + \text{Inflation Rate}} \right] - 1$$

Note the inflation rate in the above equation is the *expected* inflation rate, not the rate reported in the papers which is backward looking.

For example, let's say you can earn 5% from a one-year fixed deposit and expect inflation to be 3% over the next year. Your real return will be 1.94%:

$$\text{Real Interest Rate} = \left[\frac{1 + 0.05}{1 + 0.03} \right] - 1 = 1.94\%$$

Note we express percentages as fractions by dividing by 100. So 5% is expressed as 5/100 which is 0.05.

1.94% is very close to 2% and the approximation is perfectly acceptable in most cases.

However, I always think it's good to know how to do things correctly. Most financial journalists and financial advisors have never heard of the Fisher equation, even though earning real returns (beating inflation) is the number one goal of every investor.

Most people also think the approximation makes more sense intuitively than the Fisher equation. If your savings increase by 10% and prices rise 5%, surely you have made a real return of 5%?

The following example illustrates why the result we get from the Fisher equation – 4.76% – does actually make more sense:

Example

Buffy has £100 sitting in her bank account and uses all her money to buy a good which currently costs £1. This means she can currently buy 100 units of the good.

Alternatively she can leave her money in the bank and buy the good in a year's time. Let's assume she will earn 10% interest and the price of the good will rise by 5%.

In a year's time she will have £110 in the bank and the good will cost £1.05p. This means she can now afford 104.76 units of the good (£110/£1.05p) instead of 100.

The number of units she can afford has increased by 4.76%. This means her wealth has increased by 4.76% in real terms (and not by 5%).

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