

Savers who prefer longer-term bonds could dodge Personal Savings Allowance tax trap by 'paying away'

By Helen Kirrane thisismoney.co.uk December 12, 2023

More savers have to pay tax on their interest as savings rates rise - but the good news is that a technique called 'paying away' can help slash these bills.

In 2023, 37 per cent of savers made enough interest on their savings to breach their Personal Savings Allowance (PSA), research from Paragon Bank reveals. The annual PSA is £500 for higher rate tax payers and £1,000 for standard tax payers, while for additional-rate tax payers it is £0.

The PSA has largely flown under the radar in recent years because savings rates have been so low that almost no saver breached their allowance.

But [rising savings rates](#) have brought the issue of tax on interest back into focus.

Caught in a trap: 37% of savers breached their personal allowance in 2023, research from Paragon Bank has found. Two ways for savers to get around the PSA are to take out an Isa or put their money into NS&I Premium Bonds, as interest earned on both is not taxed. But if savers prefer the idea of longer-term fixed-rate bonds, having the interest 'paid away' can mean not handing any money over to the taxman on interest earned.

Paying away is where the saver opts to have the interest on longer-term bonds paid annually to a designated account. This technique helps avoid tax on savings interest because, under the PSA, you pay tax yearly on the interest earned in that year.

For example, a higher-rate taxpayer with £10,000 in a five-year fixed-rate bond paying 4 per cent would normally earn £2,209.97 in interest. Based on the interest earned being £1,709.97 above the £500 PSA, they would be liable to pay 40 per cent of that amount in tax, adding up to £683.99. A higher-rate taxpayer would now need a balance of just £10,000 in a non-ISA account paying 5 per cent interest to breach their PSA. But if they chose to pay the interest into a nominated account, the saver would earn the same total amount but split into five chunks of around £407 per year. That is below the level of the £500 PSA, meaning the saver owes nothing to the taxman, according to Paragon Bank's research.

Andrew Hagger, founder of personal finance website MoneyComms, says: 'If a saver took out a three year bond at 5 per cent with a £10,000 balance they would earn £500 interest per year if paid away annually. 'The problem comes if they take all the interest as a lump sum at the end of the term when for three years they would be looking at £1,500 interest, and £2,500 in interest for five years.

'When rates were, say, 2 per cent then this was less of an issue, as you'd need £50,000 to earn £1,000 interest in a year, or £25,000 to earn £500 in a year - but higher rates mean that many more people with smaller savings balance could now end up exceeding their PSA.'

If you have a longer-term fixed-rate account then some providers will allow you to change the way you receive interest mid term. Paying away means less interest overall.

Savers who choose to pay away should be conscious of the loss of compound interest that comes with taking interest by having it paid away. If the interest payment is accumulated within the fixed-rate account each year, the saver earns interest on the interest payment, as well as the initial balance.

For a higher-rate tax-payer with £10,000 in a five-year fixed-rate account paying 4 per cent, that makes a £172.97 difference in overall interest earned on the £10,000 balance.

This saver would still be better off choosing this option, as the amount paid in tax is significantly higher.

One option for savers who opt to pay away is to place the interest payment within a separate savings account paying a similar rate of interest, which should make up the shortfall.

Another way to mitigate the issue is to use a fixed-rate Isa for some of your savings pot, as this is totally free from tax.

Paragon found that over half of saver have opted to transfer non-Isa savings into Isas, while 40 per cent have opened new cash Isas.

Derek Sprawling, Paragon Bank savings director, says: 'With three out of ten savers now paying tax on their savings interest, it's crucial to employ tax-efficient strategies, such as using Isas, to protect your hard-earned savings and considering having interest "paid away" on longer-term bonds.'