Planning after the 2010 Budget

No major unexpected changes were announced in this year's Budget – most changes having been announced in the Pre-Budget Report or, indeed, in last year's Budget. However, a number of radical changes have occurred at 6 April 2010 which will have an enormous impact on clients.

Many individuals and trustees will be facing higher income tax liabilities and for some the ability to obtain higher rate tax relief on pension contributions is being severely restricted. However, the Chancellor did announce measures designed to provide some help for small businesses.

In this bulletin we look at the main changes that will affect individuals, trustees and businesses; and examine some of the related planning issues. **If you would like to discuss any of the issues covered in more detail in connection with your business or in connection with any of your clients, please contact us.**

The areas we cover are as follows:

1. Income tax and National Insurance contributions
2. Capital gains tax
3. Tax efficient investments
4. Increase in trustee taxation
5. Inheritance tax
6. Business tax
7. Pensions

1. INCOME TAX AND NATIONAL INSURANCE CONTRIBUTIONS

For tax year 2010/11

"Stealth tax activity" is again to the fore. In relation to income tax this is evidenced from the freezing of bands and allowances so that more people pay more tax. The key tax outcomes are:

- The 10% starting rate band will remain at £2,440. This applies to savings income only and so is irrelevant for most earners and pensioners.

- The basic rate of tax remains at 20%.

- The starting point for higher rate tax remains at £37,400 of taxable income.

- The standard personal allowance is frozen at £6,475. However, the personal allowance will be phased out at the rate of £1 for each £2 of income in excess of £100,000. The definition of income is, broadly speaking, gross taxable income less specified deductions, such as pension contributions and Gift Aid payments.

- The result of this reform will be that for 2010/11 the band of income between £100,000 and £112,950 will suffer a marginal tax rate of 60%; 61% if National Insurance contributions are taken into account.

- Age allowance has been held at £9,490 (age 65-74) and £9,640 (age 75 or over). The income threshold at which age allowance starts to be cut back remains at £22,900.

- *Additional higher rate of tax:* For 2010/11 there will be a new higher rate of tax of 50% (42.5% for dividends) on taxable income over £150,000. The same 50%/42.5% tax rates will also apply to trusts from 6 April 2010.

- *And, in relation to National Insurance:*

  The upper earnings limit of £43,875 continues to match the starting point for higher rate tax, once the personal allowance is taken into account (£6,475 + £37,400). In practice (see below), many higher rate taxpaying employees will face 40% tax and 11% NICs on part of their income.

  All NIC rates are also set to rise by 1% **from 6 April 2011** (although the lower earnings limit would increase to £7,020 to ensure that lower paid people are not disadvantaged). This is very likely to change now we have a new Government. Thus someone with earnings of over £150,000 in tax year 2011/12 will only retain £48 out of each £100 of earnings above £150,000.

Planning points

The introduction of a 50% tax rate for income above £150,000 and the gradual removal of the personal allowance for people with income of more than £100,000 (which gives rise to an effective tax rate of 60%) means that those affected will be more disposed to take action to reduce tax.

Furthermore, the freezing of the personal allowances and higher rate tax threshold will mean that many more people will, for the first time, become higher rate taxpayers – purely because of annual increments in pay.

The tax planning possibilities for such people will include the following:

(i) 50% tax rate

From 6 April 2010, people who have taxable income of £150,000 or more will pay 50% tax on the excess (42.5% if dividend income). For those who have investment income that will suffer this rate of tax, there are a number of options that could be considered:-

(a) Independent taxation planning

If married or in a registered civil partnership, in cases where one spouse pays a lower rate of tax (or no tax), then it can be tax beneficial to transfer investments to that spouse/civil partner.

Where the assets transferred generate interest or interest distributions, the maximum tax saving is 50%. Where the assets to be transferred generate dividend income, the maximum tax saving will be 32.5%. These maximum savings will arise in cases where the person transferring is a 50% top rate taxpayer and he/she is transferring to a non-taxpayer. Savings of 32.5% (divided income) and 30% (other income) will be available where the receiving spouse is a basic rate taxpayer.

Transfers of assets may also enable the transferee spouse to utilise their CGT annual exemption in the future (see (b) below).

Remember when the transfer is made:-

- there will be no capital gains tax – the transfer will be made on a no gain/no loss basis

- there will be no inheritance tax – the spouse exemption will apply

- the transfer must be outright and unconditional – there must be no agreement that the benefit of the assets or income will be shared with the transferor.

Remember most of these strategies are effective for a 40% taxpayer as well as a 50% taxpayer.

(b) Invest for capital growth

An investor is entitled to a CGT annual exemption of £10,100. Capital gains that exceed this figure are taxed at 18% (for the moment but note this is expected to change). Clearly, a massive disparity exists between the top rate of income tax and the CGT rate that currently applies. Whilst it might be considered unlikely that the rate of CGT will remain at this level in the future, and subject to being satisfied in regard to the potentially greater risk assumed, it would seem to make sense for higher rate taxpaying investors to consider investing for capital growth rather than income with a view to using their annual CGT exemption against encashments in the future. Suitable investments here would be capital growth oriented unit trusts or OEICs.

By making regular encashments within the CGT annual exemption, it would then be possible to use the proceeds of encashments to undertake some bed and ISA, bed and SIPP and bed and spouse planning.

As stated above, one would clearly need to balance the tax saving benefit against the potentially increased investment risk that arises from a capital growth (low yield) portfolio.

(c) Tax efficient investments

- **ISAs**

No tax relief applies on an investment to an ISA but income and capital gains produced are free of tax. Of course, the tax credit on a dividend is not recoverable and so, for the basic rate taxpayer, an ISA invested in equities gives no income tax advantage. However, for a 40% taxpayer, tax freedom means the net dividend income yield improves by 33.3% and for a 50% taxpayer by 56.5%.

Investors who are 50% taxpayers are more likely to be utilising their annual CGT exemption on a regular basis and so, for them, an investment in an ISA is almost essential. Remember the higher the rate of tax, the more the benefits of a tax-free investment such as an ISA.

- **Life assurance investment bonds**

A single premium bond (UK or offshore) can deliver valuable tax deferment for a higher/additional rate taxpayer. Consider the following features:-

- it is non-income producing so no income arises that suffers higher/additional rate tax during the accumulation period;

- a 5% tax-deferred withdrawal facility exists as a means of taking cash from the bond with no tax charge at that time;

- if encashment can be deferred to a year of lower tax or the bond can be transferred to an adult lower rate or non-taxpayer before encashment, then tax can be reduced; and

- switches can be made between different investment funds with no tax charge then arising.

Offshore bonds look particularly attractive as deferment vehicles in times of high tax rates. Due consideration does, however, need to be given to the eventual tax on realisation of gains.

- **Venture capital trusts**

Other investments exist which can reduce tax – either when the investment is made or whilst the investment is held. For example, up to 30% tax relief is available on an investment of up to £200,000 per annum into a VCT and dividend income is tax free, which is a considerable advantage in an era of high taxation. Remember VCTs usually carry more investment risk.

(ii) Loss of personal allowance

Where income which is just over £100,000 will cause a partial or full loss of the basic personal allowance, consider making a pension contribution to reduce the level of income. For extra NIC efficiency this could be made by way of salary sacrifice. It needs to be borne in mind, though, that while effective for tax and NIC purposes the salary sacrifice will not be effective to bring relevant income below the £130,000 threshold above which pension contributions and accrual will potentially become subject to a special allowance charge. Of course, where relevant income is already below this level this will not be an issue.

Where the income that is causing the loss of the basic personal allowance is investment income, there are a number of strategies that can be considered in order to reduce an investor's income and so restore the personal allowance. For example:

- transfer income-producing assets to a non or lower rate taxpaying spouse/civil partner (see (i)(a) above)

- reinvest income-producing assets into

  - capital growth oriented assets, such as OEICs and authorised unit trusts (see i(b) above)

  - consider investing in single premium bonds which are non-income producing investments (see i(c) above)

(iii) Freezing of personal allowances and the higher rate tax threshold

The impact of the freezing of the personal allowances and higher rate tax threshold in 2010/11 at the 2009/2010 level is that more people will be taxpayers – in particular more will now fall into higher rate tax. For such people who are on the border of higher rate tax and who have investments producing investment income, they could consider

- paying a contribution to a registered pension plan. This will cause the higher rate tax threshold to increase by the grossed-up amount of the pension contribution meaning more income will only be taxed at basic rate

- investing in ISAs which are tax free

- investing for capital growth via an authorised unit trust or OEIC

- investing in a single premium bond which is a non-income producing asset but which gives scope for investor access, with no immediate tax charge, via the 5% tax-deferred withdrawal facility

- investing for capital growth (subject to capital gains tax at 18%, but note comment above) as opposed to income (taxable at up to 50%).

(iv) The widening age allowance trap

A person's entitlement to age allowance depends upon their total income if they are 65 or over by 5 April 2011. A person receives the full allowance provided their total income does not exceed £22,900. Above that level their allowance is reduced by £1 for each £2 of income, although the allowance cannot be reduced below the basic personal allowance. With basic rate tax at 20% in 2010/11, the age allowance reduction means that at the margin a single person could be a 30% taxpayer, paying tax on £2 of income plus a further £1 because of the lost allowance. If total income causes a reduction in the married couple's allowance then the effective rate of tax on that income is 25%.

The sharp increase in age allowances over recent years means that bands in which the 25% and 30% tax rates could apply are now surprisingly wide. For a single person aged under 75, the 30% band now stretches from £22,900 to £28,930, while for the husband of a married couple aged 75 or over, the band extends from £22,900 to £37,820.

For a person who is age 65 or over with a total income above £22,900, they may be able to regain some or all of their lost age allowance, and thus save tax, by rearranging their investments. This need not mean reducing spendable income – the key is to reduce *taxable* income. There is a variety of ways in which a suitable reduction can be achieved, including the use of ISAs and single premium bonds. Moreover, funds can be drawn from both of these investments without affecting age allowance. Under the ISA the client can take tax free income and with regard to the simple premium bond, a 5% tax-deferred annual withdrawal can be made, for 20 years, without affecting age allowance.

2. CAPITAL GAINS TAX

No change has been announced to the rate of capital gains tax (CGT). Given the now considerable differential between the top rates of income tax and the rate of CGT, this may be a case of "the calm before the storm" but it does give people the chance to plan, particularly for short-term gains. In particular, the likely increase in the rate of CGT may mean that many people will wish to crystallise capital gains now and pay a lower rate of CGT.

The CGT annual exemption will remain at £10,100 for 2010/11.

Planning points

18% is better than 20%, 40% or 50%

A CGT rate of 18% looks very attractive if you consider that, in 2010/11; the highest rate of tax (on taxable incomes over £150,000) will be 50%.

Although, as stated above, the tax tail should never wag the investment dog (and portfolio planning must always take precedence over tax planning), there is now a stronger case for favouring growth over income when setting your investment goals. There are many anti-avoidance rules which prevent income being transformed into capital gains, but it remains the case that some financial product structures provide income returns while others produce capital gains even though the underlying investments are the same. Selecting the right structure could therefore halve a client's tax bill.

Use your annual exemption

The full annual capital gains tax exemption is worth £1,818 of tax saving. As far as possible, and subject to non-tax considerations, it is important to use this exemption each year (and for an investor's spouse/partner to do the same) because, if unused, it cannot be carried forward.

If an investor does not systematically use the annual exemption, the investor is more likely to reach a point where some of the capital gains are subject to tax; especially now taper relief has disappeared. Unfortunately, it is not possible to simply crystallise a gain by selling and then repurchasing an investment - so called bed-and-breakfasting. However, there are other ways of achieving similar results:

- *Bed-and-ISA* You can sell an investment i.e. shares in an open-ended investment company, and buy it back immediately within an ISA. For 2010/11 the maximum ISA investment has risen to £10,200 – irrespective of the investor's age.

- *Bed-and-SIPP* This is a similar process to bed-and-ISA, but the cash realised is used to make a contribution to a self-invested personal pension (SIPP). The reinvestment is then made within the SIPP. This approach has the added benefit of income tax relief on the contribution and may also offer a higher reinvestment ceiling than an ISA, depending on the person's earned income and other pension contributions. However, where somebody has relevant income of £130,000 or over, the new restrictions on pension tax relief must be borne in mind (see below).

- *Bed-and-spouse* You can sell an investment and your spouse can buy the same investment without falling foul of the rules against bed-and-breakfasting. However, you cannot sell your investment to your spouse – the two transactions must be separate.

Keeping down your CGT bill

There are a variety of tactics that can be used to limit exposure to capital gains tax, including:

- The maximisation of the use of ISAs, where there is no capital gains tax.

- The sharing of gains. Transfers between spouses/civil partners living together are on a no gain/no loss basis, so if one spouse/civil partner has not fully used their annual capital gains tax exemption and the other has, together they could save tax.

- Taking advantage of venture capital trusts (VCTs) and enterprise investment schemes (EISs). These are high risk investments, but they are generally free of capital gains tax.

Replace 40% CGT with 18% CGT

For investors who have paid CGT at a rate of more than 18% on gains made in 2007/08, consideration could be given to using an EIS investment now. An investment in an EIS allows an investor to claim reinvestment relief for any capital gain (*before* taper relief) made in the previous three years. This allows you to reclaim any tax you have paid on the gain or defer tax that is due. When you sell the EIS shares, the gain you have reinvested is crystallised and becomes chargeable, but at *current* tax rates. So it might be possible to turn a former 40% tax liability into an immediate tax repayment and an 18% deferred tax liability (but possibly a very short term window of opportunity now). The maximum amount of EIS investment that qualifies for income tax relief is £500,000 in 2010/11, but there is no limit to investment for CGT reinvestment relief.

3. TAX EFFICIENT INVESTMENTS

Individual Savings Accounts (ISAs)

Tax free investments – such as ISAs – become even more valuable as tax rates increase. The good news is that the ISA limit of £10,200 per annum (for all eligible investors from 6 April 2010) will increase annually in line with RPI from April 2011.

Venture Capital Trusts (VCTs) and Enterprise Investment Schemes (EISs)

There have been a number of minor technical changes to VCTs and EISs.

For example, currently at least 30% of the qualifying holdings of a VCT must be made up of eligible shares. This will increase to 70% in the future and make VCTs more of an equity risk investment.

Investments in newly issued VCT shares offer a number of tax advantages which will look even more attractive in an era of increasing tax rates. For example:-

- They still offer up to 30% income tax relief up to a maximum investment of £200,000 per tax year. This relief is clawed back on disposals within five years.

- Dividends within limits are tax free (although the dividend tax credit cannot be reclaimed).

- Gains within limits are free of capital gains tax.

Remember that VCT investments are high risk – the Government does not offer such attractive tax breaks without good reason.

4. INCREASE IN TRUSTEE TAXATION

The rates of income tax paid by trustees of a discretionary trust have increased by a massive 25% on 6 April 2010. The previous rate of 40% has increased to 50%; the rate of income tax on dividend income has increased from 32.5% to 42.5%.

Action

Trustees will need to pay even closer consideration to the taxation of the underlying trust investments in order to maximise returns for beneficiaries. Action they could consider would be:

- distribution of trust income to lower rate taxpaying beneficiaries

- investment in assets geared towards capital growth so that they can use their annual CGT exemption – normally £5,050 – on later encashments

- investment in non-income producing assets, such as single premium bonds, where they can

  - access the investment by making use of the 5% tax-deferred withdrawal facility

  - switch between different funds without crystallising a capital gain

  - consider assigning the bond to an adult beneficiary pre-encashment in order to reduce the tax on the encashment proceeds.

5. INHERITANCE TAX

We knew that the inheritance tax nil rate band was to be frozen at £325,000 for 2010/11. The Government have announced this will also apply for the next 4 tax years (until the end of 2014/15) and so as asset values recover more people will be caught by IHT. Of course, stated Conservative policy is to increase the nil rate band to £1 million but this is probably well down their list of priorities.

In the meantime people should be encouraged to continue to plan by:-

- making lifetime gifts that they may hopefully survive by 7 years;

- using discounted gift trusts and loan trusts as a means of transferring assets whilst retaining some access to “income”/capital; and

- putting in place, at the very least, appropriate protection policies in trust.

6. BUSINESS TAX

There were no major changes to corporation tax. The mainstream rate of corporation tax remains at 28% for the next financial year, while the small companies’ rate is kept at 21%. However, there were useful temporary changes to business tax.

Capital allowances and entrepreneurs’ relief

The Budget contained a provision to double the 100% annual investment allowance from £50,000 to £100,000. This means that the first £100,000 of capital expenditure will qualify for a capital allowance of 100% with the balance benefiting from an allowance of 20% (the 40% temporary first-year allowance having been removed).

It may be possible to use company contributions to a pension scheme to help with planning in this area. Having made a contribution to an occupational pension scheme, if it is possible for the employer company to borrow from the pension scheme, with the amount borrowed being used to purchase qualifying plant and machinery, then the annual investment allowance could be claimed.

For those looking to sell their business it seems that the 10% effective rate of CGT delivered by entrepreneurs’ relief will now be available on the first £2 million of cumulative lifetime gains following the doubling of the levels of entrepreneurs’ relief.

7. PENSIONS

The Government is severely cutting back the tax relief on pension contributions but opportunities still exist.

With effect from 6 April 2011, persons with relevant income of £130,000 or more and with gross income i.e. relevant income plus employer contributions, of £150,000 or more will start to lose higher rate tax relief on pension contributions. Once gross “income” gets to £180,000 all higher rate tax relief will be lost.

Transitional rules exist to deal with the availability of higher rate tax relief in the run up to 6 April 2011.

These rules mean that in tax year 2010/11, higher rate tax relief is restricted on contributions/pension accrual made by, or in respect of, people whose relevant income is £130,000 or more in either this tax year or in either of the previous two tax years. What is relevant income? All income (earned and investment) less gross Gift Aid donations and up to £20,000 of gross personal contributions to pension plans.

For those people whose relevant income is less than £130,000, there is no restriction on pension’s tax relief. They should therefore “make hay while the sun shines”.

For those who are caught by the £130,000 trap, the position is more complex as regards the amount that they can pay and qualify for higher rate tax relief.

Firstly, for an individual with relevant income of £130,000 or more but less than £150,000, any regular pension contributions the individual (and employer) were making before the changes were announced on 9 December 2009 can continue until 5 April 2011 with full tax relief. However, where an individual has relevant income of £150,000 or more then the relevant date is not 9 December 2009 but 22 April 2009. Regular contributions in this context are those made monthly or quarterly, although the protection is not lost if one or two contributions are missed.

Secondly, if somebody joins an employer's pension scheme and builds up a pension on the same basis as at least 20 other members, their contributions are protected from the special tax charges, whatever size they are.

Thirdly, there is a "special annual allowance" of at least £20,000. This may be increased if yearly or one-off money purchase pension contributions are paid by the individual, or by their employer on their behalf, between 6 April 2006 and 5 April 2009. Where the aggregate of these contributions divided by 3 is more than £20,000 the special annual allowance will be increased to that figure, but never to more than £30,000. If total contributions paid by the member and his employer are within the allowance there is no restriction on tax relief. The allowance takes account of any protected pension input, so if somebody has used up all of their allowance with the protected pension input they are not able to pay anything more without suffering the special tax charges.

So the moral is, if a person’s relevant income is just under the £130,000 threshold, or can be brought under it, (and did not exceed £130,000 in tax years 2008/09 and 2009/10) consider pension contributions paid personally up to £20,000 gross. From 6 April 2011, personal contributions and Gift Aid donations will not be deductible when testing against the £130,000 threshold.

If a person’s relevant income is above the threshold, see whether they can benefit from the interim arrangements. Maintain protected regular monthly/quarterly contributions if possible. For example, if a person moves job and no longer has a quarterly or more frequent contribution paid to their plan from their old employer, they can pay the full amount to that plan without losing the protection.

Also, if somebody moves to a new employer, they should consider joining any pension arrangements of that new employer. As long as there are at least 20 other members building up benefits on the same basis, they will not suffer the special tax charges. If they don't have protected contributions, it still makes sense to pay in as much as they can up to their special annual allowance of between £20,000 and £30,000.

Action

The changes are complex but opportunities for higher rate tax relief still exist provided you remain within the rules. If you have clients who are affected by these changes, call us to find out what action we would recommend.

Do not act on this information alone!

If you would like to discuss this in more detail, please contact:

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