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FINANCE MATTERS (NI) LTD

TAX PLANNING FOR 2010/2011

I think we are all aware that tax planning will become even more important going into the new financial year of 2010/11, both with the tax rates for higher paid individuals going up and also that many will be pulled into higher rate tax for the first time. As such, it is particularly important that tax planning for individuals and trustees is reviewed to ensure that maximum benefit is obtained for them, based on their individual circumstances. I have therefore looked at these areas, particularly from a financial services perspective, which I hope may be of use to you going forward.

The first area is that of income tax.

Income Tax

Income tax currently sits at 10% (on certain investment income), 20% and 40%. The four major changes with effect from 6th April 2010 are:

- The standard personal allowance is frozen at 2009/2010 rates (£6,475).
- The starting point for higher rate tax is frozen at £37,400.
- Individuals with income of more than £100,000 are likely to lose some or all of their standard personal allowance.
- Finally, a 50% tax charge will apply to taxable income above £150,000.

The net effect of this is that many more people will be falling into higher rate tax with the impact of so called “fiscal drag”. In addition, higher earners are likely to suffer a significant increase to income tax as a result of the two latter changes.

Clients may have a number of options and choices and I set out some below.

- Independent Taxation
Where we have clients who are married or who have a registered civil partner, there are tax savings possible by diverting income into the lower income partner’s name. This becomes more significant in 2010/11, bearing in mind the top rate of income tax is increasing to 50% and that there is an effective tax rate of 60% on income between £100,000 and £112,950, caused by the gradual withdrawal of the personal income tax allowance at that amount. Clearly, the method by which this diversion of income is achieved will depend on the income received, namely earned or investment income.

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As far as earned income is concerned, where the individual client runs their business through a company it may be possible for salary payments or dividends to be shared as evenly as possible, where the couple is involved in the business. This may be particularly appropriate due to the taxpayer's success in the so called "Arctic Systems" case. Clearly this requires advice from the individual's accountant/tax adviser.

The traditional route of reducing income, by way of pension contributions has become more complex and potentially less attractive for certain high earners. This is covered later in the article.

The second area is that of investment income. The tax rates for investment income are rising from 40% (32.5% on dividends) to as high as 50% and 42.5% respectively from 6th April 2010. Therefore, tax planning would suggest a transfer of investments to a lower or non taxpaying spouse, if at all practical. Clearly these transfers need to be out right and non-conditional.

With an eye to the future, it is desirable for each individual, as part of a couple, to ensure as best as possible that they have pension plans in place to provide income in retirement which will at least use up their personal allowances, bearing in mind that those personal allowances (under current rules) will increase noticeably in retirement via Age Allowance.

It is also important to consider tax efficient vehicles for investments. The obvious starting point is ISAs, particularly bearing in mind that the allowance for all, including those under 50, is £10,200 per person per tax year with effect from 6th April 2010. The use of ISAs each year is frequently overlooked for those individuals who have an existing investment portfolio, but with no new cash. Thus, part of the investment portfolio sits within ISAs, but frequently the majority sits outside ISAs, generating unnecessary tax bills. It is therefore essential for any investment review to take account of this and to systematically implement a placement of non-ISA collective investments into the ISA regime each year, particularly for high yielding, fixed interest stock where the tax benefit is greatest. This is a service we provide automatically to all our clients in our annual review package, called Client Proposition. Further details of this are available on request.

It may also be relevant to look at investments for capital growth as opposed to income, particularly bearing in mind the current Capital Gains Tax ("CGT") rates are at a flat rate 18%, but clearly may not remain so forever. Thus, growth orientated collective investments (unit trusts/open ended investment companies) may be appropriate and indeed, in certain circumstances, single premium investment bonds which are technically non-income producing. For those with a greater risk appetite, Enterprise Investment Schemes ("EISs") and Venture Capital Trusts ("VCTs") may also be appropriate.

- Loss of the Personal Allowance

This is an area where the marginal tax rate, if got wrong, can be astronomically high (at 60%) and thus it is vital to retain, wherever possible, the personal allowance for individual clients. A client whose net income is below or equal to the £100,000 limit will continue to receive the full standard personal allowance. Where the income is above this limit, the amount of allowance is reduced by £1 for every £2 above the limit, until the allowance disappears completely at £112,950.

This income figure used for this calculation effectively relates to total income subject to income tax, less specified deductions which primarily relate to trading losses, pension scheme contributions and Gift Aid contributions.

Where it is earned income which adversely affects the individual in the £100,000 to £112,950 category, they should seek to reduce their income either by paying a pension contribution or perhaps arranging a salary sacrifice.

It should be borne in mind however that a salary sacrifice arrangement reduces salary for a variety of measures e.g. sick pay or indeed mortgage calculations, so the disadvantages of such a scheme should be explored prior to implementation.

Where it is investment income that causes the difficulty, a number of measures may be appropriate:

- As discussed earlier, re-distribution of investments to a spouse with a lower income amount.
- Use of tax efficient investments.
- Use of capital growth orientated investment products such as those mentioned above, together with some National Savings products.

However, please note that neither an EIS nor a VCT will help to re-instate the personal allowance, as relief on investment into an EIS or VCT does not give rise to relief against total income. The relief is against tax otherwise payable, not income.

Pensions

This is a complex and developing area in relation to relevant income and indeed the anti-forestalling changes for those with income between £130,000 and £150,000.

For those with “relevant income” of less than £130,000 in tax years 2007/2008, 2008/2009 and 2009/2010, the provisions in relation to the special annual allowance do not apply. The definition of relevant income is broadly total income less standard deductions. Please note that the individual’s “relevant income” can be reduced by up to £20,000 by contributions paid personally during that tax year to a pension scheme or indeed by Gift Aid contributions.

So, for those with relevant income below £130,000 in tax years 2009/2010 and 2010/2011 they should consider, where cash flow permits, maximising pension contributions while there is no restriction on available tax relief. This is particularly important if they are likely to fall within the remit of the income limits applicable from 6th April 2011.

Anyone between the £130,000 and £150,000 limits need to be aware that they are potentially subject to the special annual allowance, so full advantage should be taken of this (normally an allowance of £20,000 into pensions but potentially up to £30,000 depending on previous contribution amounts and frequency). This will facilitate a potentially good pension contribution, with full tax relief.

For those with “relevant income” of £150,000 or more they should also make use of their special annual allowance (namely the £20,000, or up to £30,000 depending on conditions). This too will facilitate a potentially good pension contribution, with full tax relief.

This all leads towards the announced restriction in tax relief from 6th April 2011 in relation to pension planning for higher earners.

Thus, from then, the tax relief available to an individual within these identified criteria will be tapered away from full relief for those with gross income of £150,000 to 20% income tax relief for those with gross income of £180,000 or more.

Please also note that unlike the interim anti-forestalling provisions, there will be no protected input amounts and no special annual allowance for pension contributions.

Clearly for high earners, alternatives to pensions will need to be looked at over the next few years. I think for individuals in this category, personal advice is more important than ever. Looking at existing pension schemes, albeit with only 20% income tax relief, together with other straightforward options, such as ISAs, or indeed more esoteric solutions, may be appropriate.

National Insurance Contributions (“NIC”)

These have been to some extent flying under the radar until very recently, when the Conservatives announced plans regarding their intentions, should they win the next election.

In any event, NICs are now a very significant part of many individual’s tax contribution. For some therefore a salary sacrifice option to provide pension contributions becomes more attractive as they enable the employee to sacrifice salary (thus saving NICs) and in return the employer makes a pension contribution with the sacrificed salary plus part or all of the saved NICs.

Capital Gains Tax (“CGT”)

It seems to be received wisdom that the flat rate of CGT of 18% is in stark contrast to new income tax rates and thus it is likely that the 18% will rise. However, post Budget 2010 this is not yet the case. However, all things being equal, clients may wish to take advantage of this rate sooner rather than later.

Inheritance Tax (“IHT”)

The tax-free band remains at £325,000 and is due to remain at that level for four years, following the 2010 Budget. The Conservatives are on record as stating their policy is to increase this so called nil rate band to £1million per person during the first term of their Government.

This has been an enormously popular policy with their core voters but may be difficult to implement with the expected increase in taxes and reduction in public expenditure likely. Whatever happens, I think it is important to continue planning on the basis of current rules, as opposed to what may or may not happen in the future. I seem to remember Margaret Thatcher promising to abolish IHT, but in spite of more than a decade in power, the tax was never abolished.

For those considering IHT alleviation, there remain some excellent investment based trust solutions in the shape of Loan Trusts, Discounted Gift Trusts and general Discretionary Trusts. These are all seen as non contentious solutions.

For those who have surplus income, it may be appropriate to establish arrangements where regular gifts are made out of income to utilise the normal expenditure out of income exemption. One possible way of doing this is via a premium into a regular savings or life policy held within trust.

Where gifts to children are being considered, Bare Trusts may be used. Although this will place all capital gains to the child beneficiary, the trust capital can be claimed by the child on attaining age 18 and if the parent has established the Bare Trust, then any income generated above £100 will fall to the parents' income tax.

Where more control is required, Discretionary Trusts may be considered. It is particularly important for these trusts that the investment medium and structure is carefully thought out to ensure the most appropriate path is taken. By this means, an extremely tax efficient solution may be provided whilst both retaining control of trust assets and ensuring that the beneficiaries gain by judicious investment.

In summary, there remains significant opportunities to reduce IHT and it is a fertile and cost effective area for financial planning.

General

It may be easy to look around at the general economic climate and the impending but mainly unannounced tax increases and bow to the apparently inevitable. However, there are a variety of measures, some straightforward, some less so, which can be utilised to assist.

If you need financial planning for you or your clients, we have the experience and technical qualifications to help.

David Graham
Chartered Financial Planner

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