

SPRING PROFESSIONAL NEWSLETTER - PLANNING AFTER THE BUDGET 2009

This year's Budget proposed many important changes, particularly in the areas of income tax and pension planning for people with high incomes. Trustees will also be facing higher income tax liabilities. 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. Inheritance tax
4. Tax efficient investments
5. Business tax
6. Pensions

1. INCOME TAX AND NATIONAL INSURANCE CONTRIBUTIONS

For tax year 2009/10

- The 10% starting rate band, which caused so much controversy last year, has been increased to £2,440. As it continues to apply to savings income only, for most earners and pensioners it remains an irrelevance because it will be absorbed by earned and/or pension income.
- The basic rate of tax remains at 20%.
- The starting point for higher rate tax has risen by £2,600 (7.5%) to £37,400 of taxable income. The above-inflation increase is not all it seems because some of the tax saving will be clawed back as a result of changes to National Insurance contributions.
- The standard personal allowance has risen by 7.3% (to £6,475), while most other allowances have risen by 5%. Last year's post Budget £600 increase to the personal allowance has therefore been consolidated. However, the link

between the personal allowance and starting point for NICs will be restored in 2011/12; for now NICs start at £5,715 a year (£110 a week), £760 below the personal allowance.

- The National Insurance upper earnings limit (UEL) for employees has increased by £74 a week (9.6%), increasing NICs for higher earners by up to about £350 a year. There is a corresponding adjustment for the self-employed, who face a maximum NICs increase of about £246 a year. The new UEL is designed to match the starting point for higher rate tax, once the personal allowance is taken into account (£6,475 + £37,400 = £43,875). In practice (see below), many higher-rate taxpaying employees will face 40% tax and 11% NICs on part of their income.
- Age allowance has been increased and the income threshold at which age allowance starts to be cut back has been increased to £22,900.

For tax year 2010/11

The Chancellor also announced two changes to personal allowances and tax rates. These will apply for tax year 2010/11 onwards.

- *Personal allowances:* Personal allowances will now 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 from 2010/11 the band of income between £100,000 and £112,950 will suffer a marginal tax rate of up to 60%, assuming that the personal allowance is unchanged next tax year.

- *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 2010/11.

All NIC rates are also set to rise by 0.5% from 6 April 2011. Thus someone with earnings of over £150,000 in that tax year will only retain £48.50 out of each £100 of earnings above £150,000.

Planning points

(a) Taking advantage of the new income tax and NICs structure

Allowing for the tax and NIC changes, in cash terms, the winners are generally those earning £43,875 or more as they gain the full benefit of the increased higher rate threshold.

(b) 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 2010. 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 standard personal allowance. With basic rate at 20% in 2009/10, the age allowance

reduction means that at the margin a person could be a 30% taxpayer, paying tax on £2 of income plus a further £1 because of the lost allowance.

A similar rule applies to the husband of a married couple if one was born before 6 April 1935 and is therefore eligible for the married couple's age allowance. However, the relief given by this allowance is at a rate of only 10%, so the effective tax loss is at a rate of 25%. Not surprisingly, the married couple's relief is reduced only after all the personal age allowance is lost.

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 investment 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 investment bond, a 5% tax-deferred annual withdrawal can be made, for 20 years, without affecting age allowance.

(c) Think ahead to 2010/11

Next tax year will see the arrival of the new 50% top tax rate and phasing out of personal allowances for people who have income exceeding £100,000. The most effective tax planning is that planned in sufficient time. So now is the time to consider the following ways of minimising the impact of these changes:

- Subject to non-tax considerations, rearranging investment holdings so that dividend and interest income flows to the lower taxpaying spouse. In theory, a married couple need not worry about the 50% tax rate until their total joint income exceeds £300,000. Of course, such a strategy is also worth considering where one spouse pays 40% tax and the other a lower or nil rate.
- Bringing forward payments of bonuses or, for people who are company owners, dividends to the current tax year, when the maximum tax rate is 40% (32.5% for dividends). If necessary, these funds could then be lent back to the business.
- Closing interest-paying accounts shortly before 6 April 2010, so that interest is crystallised (and taxable) in 2009/10.
- Subject, of course, to investment considerations, realising before 6 April 2010 any chargeable event gains on life policies that you intend to encash some time in the next couple of years.

- Investing for capital growth (subject to capital gains tax at 18%) as opposed to income (taxable at up to 50%). Of course, such investments may well carry a higher risk and this will need to be carefully taken into account. The tax tail must not be allowed to wag the dog!
- Where earned income which is just over £100,000 will cause a loss of personal allowance, consider a salary sacrifice arrangement to reinstate the full personal allowance. 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 £150,000 threshold above which higher rate relief on pension contributions is withdrawn. Of course, where relevant income is already below this level this will not be an issue.

2. CAPITAL GAINS TAX

The reform of capital gains tax (CGT), which took effect from 6 April 2008, now looks to have been somewhat academic, given the falls in investment values since then. With UK share prices still languishing at levels last seen in 2003, there are few gains around on which to pay 18% flat rate CGT. However, assuming now is a good time to invest for capital growth, a tax rate of 18% on any future profits looks attractive.

Following the substantial reforms last year, in particular the reduction in the rate of CGT to 18%, the Chancellor has done very little to capital gains tax this year, increasing the annual exemption for individual investors by £500 to £10,100.

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 you do not systematically use your annual exemption, you are more likely to reach a point where some of your 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, eg shares in an open-ended investment company, and buy it back immediately within an ISA. For 2009/10 the maximum ISA investment is currently £7,200, but the limit will rise to £10,200 from 6 October 2009 if you are aged 50 or over on 5 April 2010.
- *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 your earned income and other pension contributions. However, if you have income of £150,000 or over, the new rules 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 is a variety of tactics that can be used to limit your exposure to capital gains tax, including:

- Maximise the use of ISAs, where there is no capital gains tax.
- Share your gains. Transfers between spouses living together are on a no gain/no loss basis, so if your spouse has not fully used their annual capital gains tax exemption and you have, together you could save tax.
- Take 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 2006/07 or 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 you might be able to turn a former 40% tax liability into an immediate tax repayment and an 18% deferred tax liability. The maximum amount of EIS investment that qualifies for income tax relief is £500,000 in 2009/10, but there is no limit to investment where the claim is only for CGT reinvestment relief.

Mind your losses

In current market conditions, the rules on the treatment of capital losses are arguably more important than those which apply to capital gains. These include a trap for the unwary which could mean your losses are wasted if you realise losses and gains in the same tax year with the result that net gains are less than the annual exemption. In order to maximise use of the annual exemption, if possible losses should be realised that restrict gains to the available annual exemption.

3. INHERITANCE TAX

The introduction of the transferable nil rate band in October 2007 took the sting out of the tax for many couples – but only if your planning incorporated the use of the nil rate band of each spouse. Falling house prices – the Halifax index for March 2009 is now down 21.2% from its August 2007 peak – have also helped lower the impact of the tax.

The nil rate band has increased to £325,000 in 2009/10, a move that was legislated for in 2006 by Gordon Brown.

The Chancellor announced that the availability of agricultural property relief and woodlands relief would be extended to agricultural property and woodlands situated in the European Economic Area. This change is effective from 22 April 2009, and earlier in certain circumstances.

Planning points

Time to review your estate planning

The introduction of the transferable nil rate band some 18 months ago has made inheritance tax planning considerably simpler for many married couples. It is now no longer necessary to ensure that your nil rate band is used on first death to minimise IHT liabilities. This reform can result in significantly reduced IHT bills for widows and widowers, even if their spouse died many years ago.

Not everybody has benefited from the reform. If you had already planned (and had the resources) to use the nil rate band on first death, you will be no better off as a result of the introduction of transferability. If you are not married you cannot benefit, other than as a widow/widower.

If you have not reviewed your estate planning and Wills in response to the introduction of nil rate band transferability, you should do so now. It may be that no change needs to be made to your existing arrangements but, as ever with estate planning, it is better to be safe than sorry. Even though a revised plan may not reduce your IHT bill, it could simplify estate administration by, for example, removing the need to include a complex trust in your Will.

Turn low values to your advantage

The value of most investments today is substantially lower than twelve months ago. For instance the FTSE 100 index closed on Budget day at 4018.2. At the start of April 2008 it was 5702.1.

There is one way to turn depressed investment values to your advantage, and that is by making lifetime gifts of some of those investments now. This has four main advantages:

- The value of the gift will be based on the depressed value, so any potential IHT liability is correspondingly reduced.
- While the gift will usually count as a disposal for capital gains tax purposes, the gain will be that much less (if any).
- Any subsequent growth in value of the investment is outside of your estate and, at worst, subject to 18% capital gains tax, rather than 40% IHT as part of your estate.
- It will enable you to use your £3,000 annual exemption.

If you think investments will recover, now is the time to place fresh investments into trust for your children and grandchildren.

If you wish to transfer assets outside your estate but still need to retain access, it could be worth considering a loan trust or discounted gift trust.

4. TAX EFFICIENT INVESTMENTS

Individual Savings Accounts (ISAs)

The most important change on the investment front was the revision of the ISA limits, which had been hinted at by the Prime Minister in March. However, the proposed revision is not as straightforward as it might be:

- Until 5 October 2009, the 2009/10 ISA investment limit is £7,200, of which £3,600 may be invested in the cash component.
- From 6 October 2009, the 2009/10 limit will rise to £10,200 (of which £5,100 may be in cash), but you can only take advantage of this if you are aged 50 or over on 5 April 2010.

- From 6 April 2010, the start of the new tax year, the age 50 restriction will disappear and the new higher limits will apply for all eligible investors.

Since 6 April 2008 it has been possible to transfer the cash component of an ISA, including anything from a former TESSA, into the stocks and shares component. When this option was first announced, it was widely viewed as a rather pointless facility, as for most investors the value of the income tax saving from the cash component was greater than any tax savings offered by the stocks and shares component.

However, the world has changed since this switch facility first became available. Back then, base rate was 5.25%, so that interest on the cash component of an ISA could be a meaningful amount. With base rate now just 0.5%, many existing cash ISAs are paying 1% or less.

For investors who are looking for income from an ISA, a switch from cash to the stocks and shares component now has much more appeal. For example, an investment in a corporate bond fund could produce 6% or more tax-free income. The quid pro quo for the immediate extra income is that you lose the capital security of the cash ISA and your new higher income will not rise if base rates climb and could fall. Before making the switch – which is irreversible – you should always take independent advice.

Offshore funds

Before this Budget, all distributions from offshore funds were treated as dividends, but with no attaching tax credit. Changes announced reduce the amount of tax you will have to pay on equity fund dividends, but increase the tax payable on non-equity fund income to 40% for higher rate taxpayers. The overall effect is to bring tax on offshore fund income payments largely into line with that on their onshore counterparts. If you are looking for income, the Chancellor's reworking of the 2008 Budget reform makes high yielding offshore equity funds, including exchange traded funds, more attractive.

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

There have been a number of minor technical changes to VCTs and EISs, but no increase in the rates of tax relief. For the EIS the Budget revised the backdating rules so that it is now possible to backdate the whole of an EIS investment into the previous tax year for income tax purposes. Previously only up to half of the investment (with a cap of £50,000) could be backdated. The requirement that any backdated investment must be made by 5 October in the tax year has also been removed.

Investments in newly issued VCT shares offer a number of tax advantages:-

- 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.

Current market conditions point to more investment opportunities for VCTs. The credit crunch means that banks are tightening up on lending, so more small companies will be looking for alternative sources of finance, such as VCT funds.

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

5. BUSINESS TAX

There were no major changes to corporation tax that took effect from 1 April 2009. The mainstream rate of corporation tax remains at 28% for the next financial year, while the small companies' rate is kept at 21% but set to rise to 22% in 2010. However, there were useful temporary changes to business tax.

Trading losses and capital allowances

The Budget introduced useful additional proposals to extend the carry back of losses for companies and unincorporated businesses. A trading loss may now be carried back for a period of three years, rather than just to the immediately preceding year. Only a maximum of £50,000 may be carried back beyond the immediately preceding year, and then only when profits for that year have been offset in full. These rules apply for company accounting periods ending between 24 November 2008 and 23 November 2010 and for tax years 2008/09 and 2009/10 for unincorporated businesses.

There is a temporary first-year allowance of 40% for most investment in plant and machinery for one year only from 1 April 2009 for companies and 6 April 2009 for unincorporated businesses. This allowance will apply where investment exceeds the £50,000 100% annual investment allowance and represents a doubling of the standard 20% writing down allowance.

It may be possible to use company contributions to a pension scheme to help with planning in these areas. First, because an employer contribution is deductible, it may be possible to create or enhance a trading loss that can be carried back. Second, 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 or the enhanced first year allowance could be claimed.

Planning points

Dividends or Salary ... or Pension Contribution?

The changes to NICs and the new higher rate threshold have altered slightly the mathematics of the choice between dividends and salary. Nevertheless, if you are in a position to choose between the two and not caught by the IR35 personal company rules, a dividend remains the more efficient choice.

For example, let's assume Brian has £50,000 of gross profits in his company which he wishes to draw, either as bonus or dividend. Assuming the company pays corporation tax at the 2009 small companies' rate of 21% and Brian is already a higher rate taxpayer, with annual earnings in excess of £43,875, the choice of a bonus will leave him with £26,153 in his hands (net of income tax and NICs) and the choice of a dividend will give him £29,625 (net of income tax with no NICs).

The benefit of the dividend route is due to the savings in NICs although more tax (corporation tax and income tax) is payable under the dividend route. Of course for those who want to extract maximum benefit from a company with no taxation but with no immediate access, a contribution to a pension scheme still looks most effective. For those whose relevant income exceeds £150,000, thought will need to be given to the special allowance charge – see next section.

6. PENSIONS

The Chancellor plans to restrict the value of tax relief on *all* pension contributions (including those made by employers) from 2011/12 for those with income of £150,000 or more. This will be achieved by tapering relief down from that income threshold to 20% for those with income over £180,000. Thus nobody with income of more than £150,000 will be able to obtain full higher rate tax relief on pension contributions from 2011/12.

To prevent people abusing the current rules in the run up to April 2011, the Chancellor has introduced complex 'anti-forestalling' measures. These measures, which will last for just two years, will affect people if:

- Their '**relevant income**' is £150,000 or over in the current tax year or either of the two preceding tax years;

and

- They increase their '**normal regular ongoing pension savings**'

and

- Their '**total pension savings**' during a tax year exceed £20,000 (the special annual allowance).

‘Relevant income’ is defined as total income less normal deductions and reliefs (eg trading losses) and Gift Aid, but with any deduction for pension contributions limited to a maximum of £20,000.

‘Normal regular ongoing contributions’ to a pension arrangement are:

For money purchase schemes, such as personal pensions

- The total annual amount of your contributions to the arrangement, provided that the contributions were made at least quarterly before 22 April 2009;

plus

- Any increase in your regular contributions that was agreed before 22 April 2009.

For an individual pension arrangement, such as a personal pension, a ‘normal regular ongoing contribution’ must be made to the existing (pre-22 April 2009) arrangement. If you keep the total level of your total regular contributions the same, but start to pay them to different arrangements after 21 April 2009, then such contributions are not ‘normal regular ongoing contributions’.

For defined benefit arrangements, e.g. final salary pension schemes

- All your pension savings (which are measured by reference to the change in value of your accrued benefits from one tax year’s end to the next). This is subject to the proviso that the way your benefits are calculated under the scheme rules does not change on or after 22 April 2009, except in certain limited circumstances.

The money purchase scheme requirement that contributions are made quarterly or more frequently means that no account is taken of annual payments or one-off lump sums, even though this is the typical method of paying contributions by high earners, especially the self-employed.

‘Total pension savings’ are all of your pension savings (from whatever source) that receive UK tax relief, including employer contributions. The pension savings value placed on your benefit accrual under a final salary scheme is 10 times the increase in pension plus any increase in a separate cash lump sum. For example, an extra £5,000 pension accrual is deemed to be £50,000 of pension savings.

If you are caught by the ‘anti-forestalling’ rules, then:

- You will receive full tax relief on your ‘normal regular ongoing contributions’;

but

- Any *additional* pension contributions (from whatever source) or the value of any *additional* benefit accrual will effectively be restricted to basic rate relief to the extent that your ‘total pension savings’ exceed £20,000 in the tax year.

Relief is restricted by the application of a special annual allowance charge (at 20% in 2009/10) to the additional contribution. This will be collected via your self assessment return.

Planning points

It is clearly the case that these new provisions may well apply to clients whose income is near or above the £150,000 relevant income limit. For such clients it is imperative that they take specialist pension advice before making any serious changes to their pension plans, including transfers to other schemes.

The new special annual allowance charge can never apply if your 'relevant income' for the current and two preceding tax years is under £150,000. If your relevant income is below the £150,000 threshold for 2007/08 and 2008/09, then it could pay you to keep your 'relevant income' down in this tax year (and the next) if you want to make substantial pension contributions. Stay below the £150,000 threshold and there is no risk of losing higher rate tax relief.

There are a number of ways you can limit your 'relevant income', for example:

- Ensuring that you make a personal (non-employer) pension contribution of up to £20,000
- Transferring income-generating assets to your spouse. Such transfers would be beneficial, even if you both pay higher rate tax.
- Restructuring investments to produce less taxable income.
- Making Gift Aid contributions.
- If you are self-employed, taking advantage of the £50,000 annual investment allowance to buy plant and machinery, possibly bringing forward planned investments from later years.

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