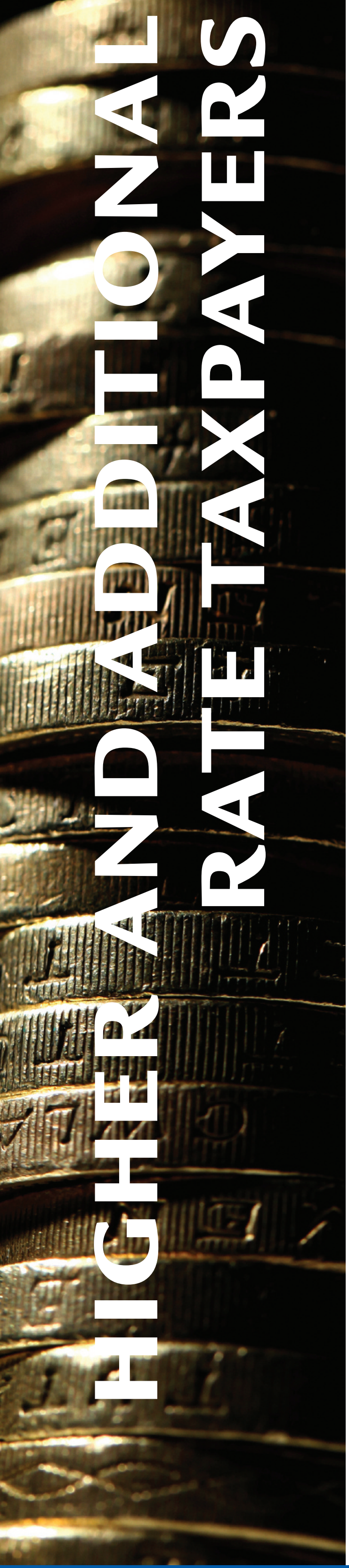
2011/12

HIGHER AND ADDITIONAL RATE TAXPAYERS



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How do you solve the puzzle of higher rate taxes?

If you now pay tax at more than the basic rate, you are not alone. There are currently 3.74 million higher rate taxpayers (40% for earnings, rent and interest, 32.5% for dividends) and 308,000 additional rate taxpayers (50%/42.5%) in the UK, according to the latest estimates from HM Revenue & Customs (HMRC).

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In spite of the country's economic woes, the numbers are increasing. Two years ago, in the 2009/10 tax year, there were over half a million fewer higher rate taxpayers and no additional rate taxpayers – 50% tax did not arrive until April 2010.

The coming tax year will probably see this upward trend continue. Although your personal allowance will increase by £630 in 2012/13, the band of income on which you pay only basic rate tax will shrink by an equal amount, so the higher rate tax threshold will be unchanged at £42,475.

The income threshold at which the personal allowance is phased out will remain at £100,000, while the additional rate will once more start at £150,000 of income.

Freezing thresholds in the face of inflation is one of the oldest and most frequently used techniques in the Treasury's extensive armoury of stealth taxes. It is likely that this well-tried method will continue to be used to gather extra revenue over the coming years. The state of the Government's finances, combined with the politics of coalition government, rule out anything approaching tax cuts at higher income levels.

The message is clear: if you want to reduce the amount of tax you pay, then the solution is in your hands.

This report explores four key planning areas for higher and additional rate taxpayers: income tax mitigation, how to efficiently realise capital gains, the key importance of pension provision planning, and how tax affects your choice of investment structures.

Thinking and planning ahead could help you to lessen the burden of higher tax rates – and we're here to help.

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Planning ahead can pay on income tax

Income tax is by far the Government's largest single source of revenue, so it is perhaps not surprising that over the years it has become more difficult both to understand and to avoid. However, there are some basic points that can help reduce your income tax bill.

Independent taxation Married couples and civil partners are taxed individually, not jointly. This opens up a range of tax planning opportunities, particularly if you and your partner pay tax at different rates on the top slice of your respective incomes. For example, if you are a higher rate taxpayer and your partner is a basic rate taxpayer, £1,000 of gross interest is worth only £600 net in your hands, but £800 in your partner's. The simple act of changing a joint deposit account to one in your partner's sole name could therefore save you tax.

It is particularly important that you both take advantage of your personal allowance (£7,475 in 2011/12, rising to £8,105 in 2012/13). Income falling within this allowance is not taxable, although tax credits on dividends cannot be reclaimed. If your income (less certain deductions) is above £100,000, the personal allowance is gradually withdrawn. The way in which the withdrawal operates means that in the band of income between £100,000 and £114,950 (£116,210 in 2012/13) you effectively suffer a tax rate of up to 60%. This trap can be another reason for restructuring how your investments are held, even if you are both higher rate taxpayers.

Similar income tax planning principles apply if you are not married or in a civil partnership. However, there may be capital gains tax and inheritance tax consequences arising from changing ownership of investments.

Income timing It could be wise to watch the timing of your income with the aim of delaying tax payments. For example, closing a deposit account in mid-March 2012 rather than mid-April will mean the final interest will be crystallised in 2011/12 rather than in 2012/13. As many accounts only pay interest once a year, that difference can be significant. The final tax bill may be little changed, but you could delay its payment for a year by choosing April rather than March for closure.

On the other hand, it may be worthwhile bringing forward your income if, for example, it would attract less tax in 2011/12 than in the next tax year. You may also want to consider investments which defer all your personal income tax liability to a timing of your choosing, something that can be especially valuable if you are likely to work or retire outside the UK.

The right type of income There are different rules for taxing different types of income. For example, if you are an employee, normally your earnings will be taxed at source under PAYE and you will pay national insurance contributions (NICs) at up to 12%, as well as income tax at up to 50%. But if you have shares in your employer, then generally the dividends are taxed at a maximum rate of 42.5%, only 10% of which is effectively deducted at source, and there are no NICs. Where you have a choice, selecting the right type of income (or fringe benefit) can cut your contribution to the Exchequer.

Children From birth, every child has its own personal allowance, and in theory can enjoy an income of £7,475 tax-free in 2011/12. In practice there are rules to prevent this if the income originates from its most likely source of parental capital. If your minor unmarried child receives more than £100 of income from capital which you have gifted, then the income is taxable as if it were yours. However, this treatment is not relevant for non-parental gifts, e.g. from grandparents or aunts and uncles, nor does it apply to parental contributions to Child Trust Funds and the recently launched Junior ISAs.

Getting the most from capital gains

Capital gains usually attract less tax than investment or earned income, although they are now taxable as income.

The top rate of capital gains tax (CGT) is 28%, a rate that applies whether you are a higher rate or an additional rate taxpayer.

Basic rate taxpayers are liable to an 18% tax rate, to the extent that the gains fall within their remaining basic rate band. CGT was reformed a few years ago, removing some (but not all) of the tax's complexities and the previous tax bias in favour of long-term holdings.

There is an annual exemption of £10,600 of *gains*, a level which will not increase in 2012/13. This is a particularly generous exemption – worth nearly £3,000 assuming a 28% tax rate – and your tax planning needs to take it into account.

■ **Use it or lose it** Any unused annual exemption cannot be carried forward from one tax year to the next. As the tax year end approaches, you should consider whether any investment gains can be realised free of tax.

The days of selling a holding one day and simply repurchasing on the following day – so called 'bed and breakfast' – are long over, but you can achieve similar results by, for example, selling a unit trust holding and then reinvesting in the same fund via an ISA.

■ **Share your gains** Independent taxation means that both you and your spouse or civil partner have an annual CGT exemption, so you can jointly realise £21,200 of gains before starting to pay any CGT.

What is more, transfers between partners are on a no-gains/no loss basis, so gains and losses can be transferred between the two of you without creating any tax liability.

■ **Time your gains** If you want to realise a gain greater than your available annual exemption, you may be able to avoid paying tax by straddling your sales over two tax years. For example, you could sell part of your holding on 5 April 2012, in the 2011/12 tax year, and the balance (after Easter) on 10 April 2012, in the 2012/13 tax year.

■ **Watch your losses** If you sell an investment at a loss during the tax year, that loss is set against any gains you make in the same tax year *before* your annual exemption is applied. Losses realised in a tax year can only be carried forward to the extent that they are not offset against gains made in the same year.

Whether these rules are beneficial or not depends upon your circumstances, but often in pure tax terms it is best to avoid realising both gains and losses in the same tax year.

Pensions – not just about retirement

The generous tax reliefs given to pension arrangements mean that they have long played an important role in countering the impact of high tax rates. However, recent Budgets have placed tighter restrictions on these reliefs, just as the arrival of 50% tax made them more valuable. Rumours continue to appear that higher and additional rate relief for contributions will be withdrawn, saving the Treasury an estimated £7 billion a year.

The use of pensions in tax planning is most easily divided into two areas: pre-retirement and at-retirement. In practice such demarcation often blurs: benefits, particularly tax-free lump sums, may be drawn before retirement and pension contributions may still be made after work has ended.

Pre-retirement planning

Your personal contributions to a pension normally qualify for income tax relief at your highest rate(s). Pension contributions reduce your taxable income, unlike venture capital trust and enterprise investment scheme relief (see 'The tax factor in investment structures'), so can help you to avoid phasing out of the personal allowance or straying into the additional rate tax band. The rules on the maximum contributions that qualify for tax relief are complex and have changed significantly this tax year.

Very broadly speaking, there is an overall ceiling (the annual allowance) of £50,000 each tax year for contributions (actual or deemed) from all sources. If this threshold is exceeded, full tax relief may still be available if total contributions have been under £50,000 in any of the previous three tax years. As a consequence, the end of this tax year could mark the last chance to exploit unused relief dating back to 2008/09. If this could be relevant to you, then seek professional advice as soon as possible – the calculation of carry forward of unused relief can be a protracted process.

Making contributions Whether or not you wish to maximise your pension contributions, it is worth considering how they are made. If you are an employee, then you (and your employer) can save NICs if you make a salary and/or bonus sacrifice in exchange for employer pension contributions. If you pay higher rate tax, the result could be an increase of nearly 18% in the amount being paid into your pension. However, salary sacrifice can have drawbacks, so again, advice is necessary.

Lifetime allowance Alongside the £50,000 annual allowance, there is also a lifetime allowance (LTA), which effectively sets a maximum tax-efficient ceiling on the total value of your pension benefits. The LTA is currently £1.8 million, but will fall to £1.5 million from 6 April 2012, after which date it is likely to be frozen until at least 2016. The LTA is subject to three transitional reliefs. You had until April 2009 to claim one or both of the first two, primary protection and enhanced protection. The lowering of the LTA has prompted the arrival of the third, fixed protection, which must be claimed by 5 April 2012.

Fixed protection will allow you to retain a minimum LTA of £1.8 million, but it will normally be lost if you benefit from any pension contributions or further pension accrual after the end of 2011/12. This makes the decision to claim fixed protection far from straightforward, unless you already have pension benefits valued at more than £1.5 million. Fixed protection is another aspect of pensions which may require urgent professional planning. For example, if you do claim fixed protection, you may also want to maximise pension contributions in the current tax year using the carry forward provisions described above.

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At retirement

The first decision at retirement is whether to draw a lump sum and an income, or just an income. At first sight, drawing the maximum cash (usually 25% of your fund or benefit value) looks the right choice because the lump sum is tax-free, whereas any income is fully taxable. However, if you are a member of a final salary pension scheme and have to commute pension for cash, the taxable income might be a better deal. The decision depends upon a variety of factors, including the pension/lump sum commutation rate, your need for capital and your state of health.

If your pension arrangement is money purchase rather than final salary, then maximising the lump sum will normally be the right move, although that does not necessarily mean drawing all the lump sum at once. How you deal with the remainder of your fund is a more complex issue:

- From a pure tax planning viewpoint, income drawdown – drawing payments directly from your fund – will often be attractive as it gives you some flexibility to tailor your pension income to your requirements and tax position. It can also help in your estate planning, as any residual fund on death can usually be passed to your chosen beneficiaries as a lump sum, subject to a single 55% tax charge.
- From an income security viewpoint, buying a traditional annuity removes the investment risk and potential unwanted reductions in income that are a consequence of choosing income drawdown. However, annuity death benefits are generally less attractive and there will be no scope to vary income each year for tax purposes.

The right structure for retirement benefits is best chosen in the run-up to retirement, but the flexibility now available underlines the fact that a retirement income is now about much more than just a fixed annuity.

Explore your pensions options with your financial adviser.

The tax factor in investment structures

Investment decisions should never be driven by tax considerations alone. If tax relief is your sole reason for a particular investment, then you should probably be putting your money elsewhere.

Tax only becomes a factor after you have decided where you want to invest. At that point, tax can help you choose between many different types of investment structure now available. Some of these structures have been specifically created by government legislation, such as ISAs, while others, such as exchange traded funds, have been developed by financial services companies.

Before examining some of the investment structures, it is worth noting that, all other things being equal, an investment return in the form of a capital gain will normally incur less tax than an income return. Over the years, successive Chancellors have struck at many investment structures designed to turn highly taxed income into lightly taxed capital gain, and few now remain.

Individual savings accounts (ISAs) ISAs have three main tax benefits:

- There is no personal UK tax on dividends, and income from fixed-interest securities is UK tax-free if held within a stocks and shares ISA. However, it is not possible to reclaim dividend tax credits.
- Interest earned on deposits in a cash ISA is similarly UK tax-free. Bear in mind that while base rates remain at historic lows, so generally do the returns available.
- Gains made within ISAs are free of CGT.

In 2011/12 you can invest up to £10,680 in an ISA, of which up to £5,340 may be in a cash ISA. From 6 April 2012, the limits will rise to £11,280 and £5,640. There is no carry forward of ISA contributions, so the way to build a large ISA fund is through regular investment.

Venture capital schemes (VCTs) VCTs are generally high-risk investments in portfolios of small companies. The inherent risk is the Government's quid pro quo for some major tax benefits:

- You can subscribe up to £200,000 each tax year in VCT shares and gain income tax relief of 30%. Relief is clawed back on sale within five years.
- Dividends from VCTs are generally free of income tax, but tax credits cannot be reclaimed.
- Gains are generally exempt from CGT.

Enterprise investment schemes (EISs) Investment in newly issued shares of EIS companies offer similar, but different tax advantages to VCTs. In 2011/12 income tax relief at 30% is available on total investments of up to £500,000, a figure which will be doubled in 2012/13.

Gains on EIS shares are CGT-free after three years, coinciding with the end of tax relief clawback. You can defer CGT on a gain by reinvesting the amount of the gain in EIS shares. There is no limit to the extent of this relief and it can be used to defer gains made up to three years before you make the EIS investment.

In 2012/13 a new variation on the EIS will be introduced, the Seed Enterprise Investment Scheme (SEIS). It will offer 50% income tax relief and up to 28% CGT relief, but the investment limit will be £100,000 and qualifying companies will have to be under two years old and have minimal assets.

Life assurance There are two types of UK life policy which can provide a useful tax shelter once other opportunities, such as ISAs, have been exhausted:

- **Maximum investment plans (MIPs)** are regular investment plans, the funds of which are currently subject to a special life company tax rate of no more than 20% on income and inflation-adjusted capital gains. You have no personal tax liability on any MIP profits at maturity, typically after ten years.
- **Investment bonds** are lump-sum investments which enjoy the same internal tax regime as MIPs. Profits, when realised, are still subject to a personal higher/additional rate tax charge, but there is scope for tax-deferred withdrawals.

Collective investment funds This investment structure used to be dominated by unit trusts, but now there is an increasing variety of investment funds. The underlying investments in a fund can normally be traded by the manager without any immediate CGT liability arising on either the fund or the investor. Funds can also offer income tax-efficiency. For example, income tax is usually charged on investment income *after* deduction of management fees. Some fund structures can allow all income to be accumulated with no tax charge until realisation.

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The secret is in the planning...

Tax rules are the subject of regular amendment – witness the hundreds of pages of legislation in each year's Finance Act. This constant state of flux means that your tax planning needs to be reviewed at least annually.

Such an assessment can determine whether your existing strategies remain valid and gauge the relevance of any new opportunities that have appeared.

The optimum date for such a review is often shortly before the end of the tax year – and preferably also before the Budget (due on 21 March this year). This allows you time to consider the use of the current tax year's annual exemptions and allowances, and the opportunity to plan for the coming tax year. You may need an additional ad-hoc review if your circumstances change, e.g. as a result of a job change or an inheritance. Please call us to arrange a meeting.