

WINTER PROFESSIONAL NEWSLETTER

50% TAX HERE WE COME

In an effort to reduce the National Debt the Chancellor has proposed that a new 50% rate of income tax will apply from 6 April 2010.

The good news is that it will only apply to people with taxable income that exceeds £150,000 in a tax year - and there are estimated to be only about 300,000 of these in the UK. The bad news is that if you are one of the people affected, it is now even more difficult to establish non-UK resident status. And, of course, there is the likelihood that, over time, if the 50% rate stays on the statute books, greater numbers will be caught by it.

So what can these individuals do about it?

Well, one good starting point is to plan early. We intend to cover this important aspect in more detail in a later issue but, in the meantime, here is a short summary of planning that such clients should be considering:-

- If married and one partner has taxable income of over £150,000, transfer investments to redistribute income so as to minimise the amount of income that falls above the £150,000 threshold.
- If the high earner is engaged in a business, consider employing or involving (through ownership and profit/dividend sharing) the other spouse in the business and re-distributing the income
- If the “offending” income is earned income, consider salary sacrifice with the sacrificed income being used by the employer to buy employee benefits – possibly with contributions to a pension scheme. However, it should be noted that any salary sacrifice effected on or after 22 April 2009 with the intention of bringing an individual’s income below the £150,000 threshold to avoid a special annual allowance charge will not be effective for this purpose.
- Consider investing in tax free investments
 - VCTs
 - ISAs
 - National Savings Certificates

- Consider investing in tax efficient investments
 - Maintain normal regular contributions to a registered pension plan where these are payable quarterly or more frequently
 - Make additional pension payments provided the total of all contributions paid – new and existing - does not exceed £20,000 in a tax year
 - Subject to investment/risk suitability for the investor, invest in capital growth oriented unit trusts/OEICs to use the annual CGT exemption
 - Again, subject to investment/risk suitability for the investor, invest in zero coupon preference shares to use the annual CGT exemption
 - Consider single premium investment bonds – non-income producing but with the 5% tax-deferred part surrender facility
- Consider emigrating to a tax haven!

We'll be back to this subject in more detail in a later issue.

HOW MANY OF YOUR CLIENTS WERE BORN BETWEEN 6 APRIL 1955 AND 5 APRIL 1959?

A perfectly natural immediate answer to this question is "I don't know and I don't care!"

However, it may be important to identify these people because they will be facing a one-off decision that can only be made before 6 April 2010.

Let us explain.

As part of its plan to encourage people to work for longer, the Government is changing the pension rules. From 6 April 2010, the normal minimum age for drawing a private pension will rise from 50 to 55. This change will come as a shock to some. Take someone born on 7 April 1960. Before this change, he would have been able to start drawing his pension from his 50th birthday on 7 April 2010. After the changes he will have to wait until 7 April 2015 – his 55th birthday.

However, anyone who will be 50 before 6 April next year still has a chance to make plans for their pension, but he/she must do so before the changes take effect. For example, someone born on 28 June 1958 was eligible to draw their pension from 28 June 2008, but if they have not started to do so by 5 April 2010, they will have to wait until 28 June 2013 - their 55th birthday.

In truth, few people can afford to retire on their 50th birthday (or their 55th birthday for that matter), but that doesn't mean that a person should not take all, or part, of their pension early. If they have a personal pension, there is no need for them to

retire when they take the benefits, but if a person is a member of their employer's pension scheme, it is worth checking firstly if benefits can be taken and, secondly, even if they can be taken, whether the employer will stop their payments into the fund if benefits are taken early.

This decision on whether to take benefits could be particularly important where a member wishes to take his tax-free cash.

In brief, what does this mean?

This will mean that a certain group of people, namely those born in the five years prior to 6 April 1959, will need to make early important decisions about their pension benefits. The individuals in this category will, due to their age, have a short window prior to 6 April 2010 in which to decide whether to draw a part of their pension rights from age 50. If they do not they will be prevented from drawing further benefits until age 55.

Are there any other matters that will affect the decision?

There are a number of considerations that need to be addressed in deciding whether to take benefits. For example:-

- Does my scheme permit me to draw my benefits now? If it does, and my benefits are taken before my scheme's Normal Retirement Date, will there be penalties imposed for taking my benefits before that date?
- Do the current market conditions impact on my decision?
- What will I do with my tax-free cash – repay any mortgage; invest it?
- Do I forego any potential future benefits by taking my benefits now?
- If I want to take my benefits now and am unable to do so under my current scheme, will it be advantageous to transfer my benefits to another scheme to enable me to do so?

These and other issues need to be considered prior to making an informed decision. This is where independent financial advice will prove of great benefit.

ACTION

If you have clients in the above position, they will need to seek professional advice on the best means of ensuring that the change in the "normal minimum pension age" to 55 does not disrupt their retirement plans or adversely affect them. Call us for more information.

MAKE THE MOST OF THE TAX RELIEF WHILE YOU CAN

The 2009 Budget confirmed the Government's intention to cut back on a person's ability to obtain higher rate tax relief on pension contributions. With effect from 6 April 2011, anybody with a total income of more than £180,000 will not qualify for any higher rate tax relief. Those with income between £150,000 and £180,000 will find a cut back in the amount of higher rate tax relief. Those with income of less than £150,000 will still fully qualify for higher rate tax relief.

The writing is therefore very much on the wall as far as tax relief for these people is concerned. But what happens in the two tax years before these rules become effective?

Well, in its paranoia to prevent these high earners throwing money at pension schemes, the Government has introduced some anti-forestalling rules. These complex anti-avoidance rules fly in the face of pension simplification. The rules can apply to a person who satisfies the following three conditions.

- (i) in the current tax year (or in either of the previous two tax years) the person's income (earned and unearned) has exceeded £150,000
- (ii) the person has increased his pension contributions or pension accrual above any protected pension input levels applying prior to the Budget. For this purpose any "regular" (as defined in (b)(1) below) contributions in force prior to Budget Day (22 April 2009) and any benefits accruing under a final salary scheme of which the individual was a member on 21 April 2009 will normally represent protected pension input where these contributions and/or accrual continue to apply on or after 22 April 2009
- (iii) pension provision in the tax year in question exceeds the greater of the amount of the protected pension input or the special annual allowance (i.e £20,000, although, in certain circumstances, this may be increased up to £30,000 – see below). Any pension contribution paid between 6 April 2009 and 21 April 2009 will also be protected from any tax charge in 2009/10 and included in the protected input amount.

It will, of course, be readily appreciated that not many people will satisfy all of these criteria, especially taking into account:-

- pre-Budget pension arrangements involving regular monthly/quarterly contributions of any amount are protected
- pension contributions made by the person of up to £20,000 gross can be deducted from his income to determine whether the £150,000 income limit is breached
- the fact that, in certain circumstances, the Government has now increased the special annual allowance to up to £30,000 where contributions are paid less frequently than quarterly (ie normally annual or single contributions).

Although the changes relate only to those with income of £150,000 or more in a tax year this may well be seen as the precursor to the phasing out of higher rate tax relief on pension contributions at all income levels. Action to be taken is therefore clear:

- (a) Clients who are potentially caught by these new rules should take specific pensions advice before making changes to their pension provision – otherwise they run the risk of upsetting current tax efficient arrangements and losing tax relief. This particularly applies if they are considering terminating regular contributions under an individual arrangement, where these contributions are currently protected from any tax charge, and continuing these under a new arrangement where no such protection will apply.
- (b) For those clients who are caught by the new provisions, and who are not paying their maximum contributions that still qualify for higher rate tax relief, they should now do so.

The total amount they can pay, and on which they can obtain full tax relief, will depend on their circumstances. In brief terms:-

- (i) for people who do not have any protected pension input (ie regular contributions payable at a frequency of at least quarterly or any pension contributions paid between 6 April 2009 and 21 April 2009) £20,000 in total in this tax year can be paid and relieved at the higher rate
- (ii) for people who have protected pension input of less than £20,000, they can make up the shortfall. If they currently have protected pension input of £20,000 or more, no additional contribution can be paid over and above the protected quarterly/monthly contribution they already pay
- (iii) for people for whom annual or single contributions have been paid in the last three tax years averaging more than £20,000, their special annual allowance is increased up to that average figure, subject to an upper limit of £30,000. This will enable contributions to be paid as indicated in (i) and (ii) above but up to the level of the increased special annual allowance rather than £20,000.

Please bear in mind that this is a simplification of the rules and there is no substitute for specialist advice.

- (c) Clients who in this tax year and the previous two tax years have substantial income, but less than £150,000 in a tax year, should give serious consideration to maximising contributions to their pension plans now – whilst they fully qualify for higher rate tax relief on their contributions. Given this recent attack on higher rate relief for pension contributions paid by persons with a high income, there can be no guarantee that higher rate tax relief will always be available in the future.

ACTION

The new rules on restricting higher rate pension tax relief are complex. But they send out a clear message – act now before it's too late. Call us for further information.

TRUSTEES SHOULD ACT NOW BEFORE THE TAX HIKE

One item of news in the Budget that received a significant share of publicity was the proposed increase in the top rate of income tax for individuals to 50% from 6 April 2010. This rate only applies to income in excess of £150,000. For trustees of a discretionary trust though the proposed tax hike – to 50% (and 42.5% for dividends) from 6 April 2010 – applies to all income that exceeds their standard rate band of, normally, £1,000. This represents a 25% increase in tax rates for these trusts which will apply in about 7 months' time. Given the difficult investment conditions that trustees have faced over the last year, they should be keen to take action to limit the impact of this tax change. Here's a few tips:

What's happening

From 6 April 2010, the trust tax rate will increase from 32.5% to 42.5% on dividend income and 40% to 50% on other income. This will apply to income in excess of the trustees' standard rate tax band, which is normally £1,000. Trustees will pay this rate of tax on income they accumulate and distribute.

Of course, if income is distributed, the trustees' tax bill is, in effect, a payment on account of the beneficiary's liability to tax. In the case of settlor-interested trusts, irrespective of whether income is distributed, it will be the settlor who has the tax liability and the tax payment by the trustees will count as a credit for the settlor in determining his tax bill.

On the other hand, assuming there are no changes on the CGT front before then, trustees will pay 18% CGT on chargeable gains that exceed the annual trustee CGT exemption (currently normally £5,050).

Planning for trustees

So, for trustees who are likely to be affected by this change, what action should they take? We believe that three particular areas should be considered:-

(i) Distribution of income

The trustees could consider distributing income to beneficiaries. In such a case, the income tax they pay is, in effect, a payment on account of the beneficiary's liability to income tax. In most cases this should enable those beneficiaries to recover some (and in some cases, all) of the income tax paid by the trustees. This will be

particularly beneficial where the distribution is made to basic rate taxpaying beneficiaries or non-taxpaying beneficiaries. This strategy will not work in cases where there is a "settlor-interested" trust because then all trust income is assessed on the settlor irrespective of whether and to whom it is distributed. And it will not be possible to reclaim the notional 10% tax credit on dividend income in any circumstances.

(ii) Investment for capital growth

The trustees could consider investing for capital growth rather than income. By investing for capital growth the trustees will be able to use their annual CGT exemption against capital gains that arise on disposal. Currently this is £5,050 where the settlor of the trust has only established one trust. Capital gains that exceed the annual exemption will only be taxed at 18% as compared to the maximum 50% tax that can apply on income from the next tax year. Naturally, tax must not be the only determinant when making investment decisions. Risk and suitability (both especially important with growth-oriented assets) have to be fully taken into account.

(iii) Tax efficient investments

Thirdly, the trustees should consider income investing in potentially more tax efficient investments within the trust, such as single premium insurance bonds.

This is especially so where trustees wish to invest in income producing investments. Where the income is to be tax effectively reinvested, a single premium insurance bond (Bond) investment could offer a tax effective solution. Income that arises to a UK insurer will suffer a lower rate of tax at life fund level than income received from directly held investments by a higher or additional rate taxpayer.

For example, savings income and rental income will suffer 20% tax within a UK life fund which is lower than the 50% rate that could apply from 6 April 2010 to direct investments held by a trust. As far as UK dividend income is concerned, this suffers no tax within the UK life fund whereas dividend income from directly held investments could suffer income tax at 42.5% from 6 April 2010 whether it is reinvested or not.

As usual, it is also necessary to consider income tax on encashment of the Bond. At that time any chargeable event gain will be taxed on either the settlor or the trustees but, either way, there will be a 20% tax credit for internal tax suffered within the life fund.

In contrast, under an offshore Bond there will usually be no tax on underlying income and gains. However, there will be no 20% tax credit on chargeable event gains on encashment.

Whether an offshore or UK Bond will offer the most tax effective solution will depend on the circumstances, including the make up of the underlying fund and the likely investment term of the Bond.

A UK or offshore Bond therefore offers scope for tax efficient accumulation of investment income with scope to adjust the underlying investment fund by tax free switching between funds. Furthermore, should the trustees need to distribute cash to a beneficiary they can access the Bond (and some of the growth) by making use of their annual 5% part surrender allowances.

The Bond's tax effectiveness will, in most cases, be most accurately described as tax deferment as, on final encashment, such withdrawals will be brought back into account. At that time trustees should therefore consider tax efficient encashment strategies. For example, the trustees could make an assignment to a non-taxpaying or a basic rate taxpaying adult beneficiary before the Bond is finally encashed. No chargeable event will arise on this assignment and, hopefully, a lower tax bill will result on final encashment by the beneficiary.

A Bond therefore continues to offer tax efficient investment to certain trustees and, if tax rates do go up, the appeal of the Bond may be enhanced in the future. But there are some downsides to using a Bond:-

- (i) A Bond will not enable trustees to use their annual CGT exemption or access the single 18% rate of tax on capital gains in excess of this exemption and
- (ii) Bonds, as non-income producing assets, are not appropriate for trustees of life interest trusts where there is a desire to pay an income to a beneficiary.

ACTION

With a significant increase in the rates of trust taxation on the horizon, now is the time for trustees to consider maximising the tax efficiency of trustee investments. Call us for more information.

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