

CLIENT MEMORANDUM

THE ATTACK ON HIGHER-RATE TAXPAYERS

The era of manageable income tax rates for higher earners looks set to be brought to an end. Reductions in the level of income tax started under Geoffrey Howe in the Thatcher administration and have continued ever since, notwithstanding political changes. It now appears that the current economic crisis has brought the era of low tax rates to an end for the foreseeable future. Certain increases in personal tax rates have already been announced to take effect from 6 April next year and, although there could be a change of Government, it does not seem that any political party has room for manoeuvre in this area.

Although the announcements have most impact on those with incomes in excess of £150,000, there are also to be changes affecting those on incomes in excess of £100,000. Whilst the financial columns in weekend papers have included a variety of suggestions as to what advance planning can be carried out, many of the ideas we have seen will not stand up to detailed scrutiny. Nevertheless, there are steps which can usefully be taken this year in order to mitigate the effect of the forthcoming changes, and an outline of these is set out below.

The new tax rates

The changes which have been announced so far are:

- For those on incomes in excess of £100,000, the income tax personal allowance will be subject to a tapering reduction. For this purpose, it is first necessary to calculate the “adjusted net income” for the year, which in broad terms is gross income less various tax reliefs or deductions, such as relief for trading losses, pension premiums, and gift aid contributions. Where adjusted net income exceeds £100,000 for 2010/11, the personal allowance will be reduced by £1 for every £2 in excess. So, for example, if the personal allowance is £6,500, that allowance will reduce to nothing when adjusted net income reaches £113,000.
- There will be a new higher rate of income tax of 50% with effect from 6 April 2010 which will apply to incomes over £150,000. For those in this tax band, the higher rate of tax on dividends will be 42.5%, in place of the present 32.5%, this new dividend rate applying to any dividend income falling in the excess of income over £150,000. All dividends will continue to carry a tax credit of 10%, available as a deduction from the higher rate, with the actual dividend payment being treated as net of this tax credit. Mathematically, therefore, the new dividend rates work out at 36.1% of the amount actually received for any dividend falling in the band of income in excess of £150,000, and 25% (as at present) for any dividend falling into higher rate income tax, but below the new £150,000 band.
- Similarly, trust income liable at the rate applicable to trusts (for example, discretionary trust income) will be liable to tax at 50% for non-dividend income, in place of the present 40% rate, and that dividend trust rate will be increased to 42.5%, on the same basis as described above for personal taxpayers in the 50% band. Note, however, that these high rates of trust tax will apply to all income in the trusts concerned, apart from a lower rate band applicable to the first £1,000 of income.
- From 6 April 2011, tax relief will be restricted for pension contributions made by those with incomes in excess of £150,000 either in the year in question or in either of

two previous years. The restriction will be applied so that higher rate relief on pension contributions is tapered away within a band of annual income from £150,000 to £180,000. Over £180,000 of relief will be worth only 20%, the same as for a basic rate taxpayer.

An indication of the marginal rates of tax which will apply for 2010/11 are set out in the table below. This to be used as a guide only as each individual's personal tax position is affected by the reliefs which may be available to him or her.

Marginal Tax Rates – 2010/11

Income from £	Income to £	Non income %	Savings Savings income %	Dividend plus tax credit %
6,475	43,875	31.00	20.00	0.00
43,876	100,000	41.00	40.00	32.50
100,001	112,950	61.00	60.00	48.75
112,951	150,000	41.00	40.00	32.50
150,000		51.00	50.00	42.50

Note: assumes personal allowance is the same as for 2009/10

Forward planning

Some steps which you might consider in advance of the introduction of these rates are set out below:

1. The new ISA allowance will be £10,200 for 2010/11 and for those aged 50 and over in the current tax year, this allowance will be available from 6 October 2009 as well. It will clearly be important to ensure that both husband and wife make full use of their ISA allowances, as income and capital within these tax exempt funds are fully sheltered from personal rates of tax.
2. It will now be all the more important to ensure that investment income is suitably distributed between husband and wife so as to minimise the impact of the new rate tax thresholds. To achieve this, shares should be transferred outright between the parties as appropriate - it will not work simply to divert the income on investments to the bank account of the spouse. Please consult us on the details.
3. Certain offshore funds - described as non-reporting funds - accumulate their income so that there is nothing to declare for income tax purposes until the investment is encashed. Note, however, on encashment all the profits will then be liable to income tax and the capital gains tax rate will not apply.
4. Single premium life insurance investment bonds are also investment vehicles which enable income to be accumulated within the bond and there is no income tax position until full or partial encashment. However, UK investment bonds are not particularly tax efficient, since income and capital gains within the bond are liable to tax at corporate tax rates, whereas on encashment the credit given to the investor is only 20%. There are also relatively high commissions charged within the funds.
5. Self-employed taxpayers who have trading losses in the current tax year should consider the various options they have as regards obtaining relief for these losses.

- Will they be better carried forward to 2010/11 when relief might be available against income in any of the new higher rate bands?
6. Self-employed taxpayers should also make sure that their closing work in progress for accounts falling within the current tax year is fully valued and included in those accounts. Closing work in progress forms part of taxable profits for those accounts but, equally, it is a deduction in the accounts for the following year, which will fall within the new higher rate tax regime.
 7. Although there are to be restrictions, discussed below, as regards pension premium relief where annual income exceeds £150,000, this will not apply below that level of income. Accordingly, any taxpayer with income for 2010/11 marginally in excess of £100,000 could find that pension premiums paid have an effective rate of tax relief of 60%, as already explained.
 8. Businesses which are planning major capital expenditure on equipment, and which may be affected by the new forthcoming high rates of tax, may find that there is better effective tax relief for the outlay after the accounting period in the current tax year has closed. There is an annual investment allowance for all businesses of £50,000, this applying to purchases of new equipment, with notable exceptions such as business cars. This investment allowance may therefore give better tax relief in the accounting period which closes in 2010/11 than in the current accounting period.
 9. Those operating as sole traders or family partnerships could consider whether it would be suitable to incorporate the business. There are tax reliefs for the transfer of business assets to a company and it may be possible to sell goodwill to the company in exchange for a loan from the company, to be repaid free of income tax liability on the lender in future years. Corporate tax rates are lower than personal tax rates (21% for small companies and 28% for larger companies) and therefore so long as all the profits are not drawn as salary or dividends, a company will lower the overall tax burden. In addition dividends paid out do not suffer the National Insurance charges which can apply to remuneration (12.8% on the company and 11% on the employee subject to an upper limit). It will be appreciated that the issues involved with incorporation are not solely tax-related and this major step requires full review on an individual basis.

Planning for larger businesses

There are different possible planning steps for more substantial trading enterprises, but these would require detailed specific advice in each case.

Employee Benefit Trusts

These have been much used in recent years for tax avoidance and, accordingly, they have attracted considerable interest from HM Revenue & Customs. There have been significant changes in the law and the best advice is not to use them provocatively. However, funds paid into a trust from a business give rise to no immediate tax charge on the employee and the funds can be invested within the trust in whatever manner the trustees decide. The normal restrictions which apply within pension funds are not applicable. The legislation relating to these structures permits no tax relief for the funds paid in to be given until such time as the trustees release funds in taxable form to beneficiaries; suggested mechanisms for achieving a tax deduction without the outgoing tax charge are not recommended here as HM Revenue & Customs will regard these as unacceptable tax avoidance.

Issue of further shares in trading company

Where a trading company business is being conducted within a family company, the shareholders may wish to review whether income can be accumulated within the company

outside the personal tax regime and the value received upon a later disposal of the shares when the gain will be charged to the capital gains tax of 18%. As a matter of theory, this is feasible but it requires detailed review as to how the funds will be employed within the company in the meantime and what the prospects are for sale of shares in the longer term. Employees of larger companies could take a reduced salary on terms that they will receive in exchange for an issue of shares in the company. Salary sacrifice arrangements need careful implementation and it is likely that there will be an income tax charge on the issue of shares, but overall there could be a tax advantage. The best position would be if the benefit in exchange for the salary sacrifice is further approved share options in the company as these do not normally give rise to income tax charges, but instead profits on the shares are within the capital gains tax regime.

As regards privately held investments, as a matter of theory the use of a company to hold the investment assets enables the income from them to be accumulated within the company outside the personal tax regime. However, private investment companies are not normally considered for holding quoted shares, but substantial property holdings may be more suitable. This is a specialist area upon which we can advise further. It can sometimes be possible to transfer property investments into a company without triggering liability to capital gains tax on the accrued gains, by means of the special capital gains tax reliefs applicable to incorporations of businesses.

Trustees of discretionary trusts should consider making revocable appointments of the trust income to one or more beneficiaries. Most discretionary trusts give the trustees wide powers and that being so they may therefore exercise those powers so as to give one or more beneficiaries the entitlement to receive all, or a share in, the income of the trust until such time as the trustees decide otherwise. After any such appointment the trust income covered by the entitlements is then returned by the beneficiaries themselves on their personal tax returns, and the rates applicable to trusts no longer apply to it. We can advise whether this may be appropriate in any particular case. The relevant trust deed will prescribe the manner in which appointments are to be made, but often a deed is required which will require professional drafting.

New restrictions on pension contributions

The Finance Act 2009 contains legislation to restrict tax relief for 2011/12 et seq for individuals with income of £150,000pa or more. Relief will be tapered so that for those earning over £180,000pa relief will be worth 20% as for basic rate taxpayers. It is not yet known exactly how the tapering will work, but it is expected that an individual with income of more than £150,000 in 2011/12 and paying personal contributions to a pension scheme in that year which would qualify for higher rate tax relief will only be able to obtain tax relief at the basic rate on those contributions. Tax relief at the basic rate of tax will continue to be given on contributions either via relief at source or the net pay arrangement.

The Finance Act 2009 also contains legislation that will apply from 22 April 2009 restricting higher rate tax relief on personal pension contributions. The restrictions will apply to individuals with income of £150,000pa or more in 2009/10 or in either of the two preceding tax years who change their ongoing regular pension savings and whose annual pension contributions exceed £20,000, or in some cases up to £30,000 (see below). These latter provisions are intended to forestall individuals from increasing their pension contributions in excess of their normal pattern. A new special annual allowance tax charge of 20% may apply where pension savings exceed £20,000 and will be collectible via self-assessment.

Example: Annual income £200,000 and normal regular pension savings £15,000pa. After 22 April 2009 additional contributions of £10,000 are made. There have been no other irregular contributions in the tax years 2007/08 to 2009/10. The special annual allowance tax charge would apply to £5,000, ie total savings of £25,000 less £20,000.

Regular pension savings are not caught by the proposals, eg contributions at the same level, by percentage or amount, as before 22 April 2009 nor are contributions to new pension arrangements for schemes of 20 or more members. Irregular contributions and one off lump sum contributions may be caught however. To allow for individuals who make annual contributions or who contribute to money purchase pension schemes as their circumstances permit where irregular contributions have been made over the past three years, the special annual allowance is increased to the average of those contributions if it is more than £20,000 with an upper limit of £30,000.

The special annual allowance and related tax charge apply to total contributions regardless of whether they are paid by the individual, employer or a third party. Any salary sacrifice arrangement entered into on or after 22 April 2009 in return for pension contributions or additional pension benefits will be included in calculating an individual's income for 2009/10.

It is most important that clients with income of £150,000 or more in 2009/10 or in either of 2007/08 or 2008/09, who are contemplating paying contributions in 2009/10 that exceed regular contributions by £20,000 or irregular contributions, should seek advice well in advance of 6 April 2010 before making such contributions to ensure they are not caught by the forestalling provisions.

FOR GENERAL INFORMATION ONLY

Please note that this Memorandum is not intended to give specific technical advice and it should not be construed as doing so. It is designed to merely alert clients to some of the issues. It is not intended to give exhaustive coverage of the topic.

Professional advice should always be sought before action is either taken or refrained from as a result of information contained herein.