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MONEY NEWS

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# END-OF-YEAR TAX PLANNING

The run up to the tax-year end is a good time to consider tax planning to maximise the use of an individual's allowances, reliefs and exemptions for the current tax year. Some of these will be lost if not used before the tax-year end. For those people who currently pay higher rate (40%) income tax and additional rate (45%) income tax, tax planning at the end of this year is absolutely vital as a means of minimising tax payable and so maximising net income, capital gains and wealth.

As well as last-minute tax planning for 2016/17, now is also a good time to put in place strategies to minimise tax throughout 2017/18.

In this newsletter we cover the main planning opportunities open to UK resident individuals for tax year 2016/17, which ends on 5 April 2017, and look at strategies and disciplines which could be put in place to minimise tax in 2017/18.

While tax planning is an important part of financial planning, it is not the only part. It is essential, therefore, that any tax planning strategy that is being considered also makes commercial sense.

**In this newsletter all references to spouse include civil partners and all references to married couples include registered civil partners.**

## 1. INCOME TAX PLANNING

The following are the main income tax factors that are relevant for 2016/17:-

(i) The personal allowance is £11,000. Since 6 April 2015 it has been possible, for a non-taxpaying spouse, to transfer 10% of their personal allowance to their spouse provided the recipient spouse is not a higher rate taxpayer.

(ii) The threshold for the start of higher rate tax on taxable income is £32,000 in 2016/17.

(iii) A 45% tax rate applies to taxable income that exceeds £150,000.

(iv) People with income of more than £100,000 lose some or all of their standard personal allowance.

(v) The introduction from 6 April 2016 of a new regime for charging dividends to income tax. This is beneficial for many investors who receive dividends from investments but is

disadvantageous for shareholder/directors who draw remuneration from their company in the form of dividends.

(vi) The introduction of a new personal savings allowance which now means that savings income of up to £1,000 (basic rate taxpayer) and £500 (higher rate taxpayer) will be tax free.

There is no doubt that the number of people who pay higher rate tax is increasing. The impact of (iii) and (iv) above will also mean that people with income of more than £100,000 will continue to pay marginal rates of income tax of up to 60% on some of that income.

Tax increases can be combatted in a number of ways including:-

(i) Maximising the use of all of a couple's allowances, reliefs and exemptions.

(ii) Planning to use the new allowances on savings income that have applied since 6 April 2016.

(iii) Planning for the new dividend tax changes.

(iv) Using tax-efficient investments.

We will now consider these in more detail.

## 1.1 PLANNING FOR PEOPLE WITH INCOME OF BETWEEN £100,000 AND £122,000 OR THOSE WITH INCOME OF MORE THAN £150,000

Planning to maximise the use of a married couple's allowances, reliefs and exemptions has become even more important for those whose top rate of income tax is 45% because they have taxable income of more than £150,000. For such people who are married, the tax savings available by diverting income into the lower-income recipient's name will be even more substantial. The tax savings that can arise from such planning can be just as important for the higher rate (40%) taxpayer who is married to a lower-rate or non-taxpaying spouse. And don't forget that because of the government's changes in the tax rules, the number of higher rate taxpayers is increasing.

Similar planning may be appropriate for couples where one has income of between £100,000 and £122,000. Where an individual's adjusted net income is above the income limit of £100,000, the basic personal allowance will be reduced by £1 for every £2 above the income limit. The personal allowance can be reduced to nil from this income limit. For example, based on the basic personal allowance of £11,000 for 2016/17, an adjusted net income of £122,000 (£123,000 in 2017/18) or above would mean that no personal allowance is available and non-dividend income in that £22,000 band is being effectively taxed at 60%.

Most of these strategies need a full tax year to deliver maximum impact so these suggestions may serve more as a reminder to plan ahead for the coming tax year than as a "last minute" means of saving tax this tax year. The appropriate type of tax planning to adopt will depend on the type of income a person enjoys ie. earned/business income or investment income.

Even more people will fall into this trap in the future as the personal allowance is set to rise. In his Autumn Statement the Chancellor confirmed that the personal allowance would increase to £11,500 in 2017/18 meaning that those with income of £100,000 - £123,000 will be caught. By the end of the current Parliament, the personal allowance is expected to increase to £12,500 which will mean that this "60% band" will increase to £25,000.

*(i) Earned income*

Where it is earned income that takes the individual into the £100,000-£122,000 bracket they could consider reducing this by adopting one or both of the following strategies:

- paying a pension contribution, or
- arranging for a salary sacrifice.

The marginal rate of tax in the £100,000-£122,000 band of earned income is 60%. It may therefore be possible to obtain 60% tax relief on some pension contributions.

*(ii) Investment income*

Where it is investment income that causes the individual's adjusted net income to fall into the £100,000-£122,000 band then, depending on their circumstances, any of the following may be appropriate strategies:-

- Redistribution of investment capital to a spouse with a lower income so that the income generated is taxed on them instead. No capital gains tax (CGT) or income tax liability will arise on transfers between married couples or where the asset to be transferred is a single premium investment bond.

- Reallocation of dividend income for couples who run their business through a company. Where they are planning to transfer shares to achieve this, it is important that any share transfers are made by way of an unconditional gift with full voting, capital and income rights – the transfer will not incur CGT where the couple are living together and married. Remember that income that falls within the investor's £5,000 dividend allowance (see below) still counts as part of total income, even though it is tax free.

- Reinvestment in tax-free investments, such as an ISA, so that taxable income is replaced with tax-free income – see section 1.5 below.

- Reinvestment in tax-efficient investments that generate no income and so will not contribute to the loss of the personal allowance. Such investments would include:-

  (i) Unit trusts/OEICs geared to producing capital growth.

  (ii) Single premium investment bonds from which a 5% tax-deferred withdrawal may be taken each year, for 20 years, without affecting the personal allowance calculation.

It is important to note that investing in an EIS, a SEIS or a VCT will not help to reinstate the personal allowance by reducing an individual's income. This is because tax relief on investment in an EIS, SEIS and VCT is given by a reduction in the tax bill and not by a reduction in total income.

## 1.2 MAXIMISING USE OF ALL OF A MARRIED COUPLE'S ALLOWANCES, RELIEFS AND EXEMPTIONS

Couples should generally plan to maximise the use of both of their personal allowances.

- Clients should make maximum use of all the personal allowances available to them and their family. A husband and wife each have their own personal allowance. This is particularly relevant where one spouse pays tax at a lower rate than the other. A non-working spouse with no investment income will be able to receive income of £11,000 for tax year 2016/17 before they pay any tax. Of course, where this income is earned income and it exceeds £8,060 (2016/17), there will be a National Insurance liability.

- Where possible, a couple should try to ensure that they both have pension plans that will provide an income stream in retirement that will enable them to both use their personal allowance.

- Older married couples have traditionally benefited from an increased age-related personal allowance. However, this allowance has been overtaken by the standard £11,000 allowance in 2016/17. Therefore, no tax saving can be achieved by transferring assets between a husband and wife to use this allowance.

## 1.3 THE INVESTMENT ALLOWANCES INTRODUCED IN 2016/17

*Personal Savings Allowance*

With effect from 6 April 2016, a new personal savings allowance (PSA) was introduced. Savings income that falls within the PSA is tax free. For basic rate taxpayers the PSA is £1,000, for higher rate taxpayers £500 but no allowance is available for additional rate taxpayers.

Savings income includes bank and building society interest (which since 6 April 2016 has been payable gross), the non-capital element of a purchased life annuity, chargeable event gains on offshore bonds, gilt/corporate bond interest and income from collectives that are invested as to at least 60% in cash/fixed income stock.

The PSA is available in addition to an individual's personal allowance and £5,000 zero rate savings band and so, in theory, for a basic rate taxpaying individual with only savings income, they can receive up to £17,000 per annum tax free. Income within the PSA will use a part of the individual's basic rate tax band.

All taxpayers should endeavour to invest in such a way that they use their tax free savings allowance.

*Dividend allowance*

Since 6 April 2016, all individuals have been entitled to a dividend allowance of £5,000. Full details of dividend taxation is given in 1.4 below but all investors should seek to utilise this dividend allowance to maximise tax free income.

## 1.4 DIVIDEND TAXATION - ALL CHANGE

*General*

With effect from 6 April 2016, significant changes took place in the taxation of dividends. The main changes were as follows:-

- The non-reclaimable 10% dividend tax credit was scrapped;
- A new dividend allowance of £5,000 was introduced in 2016/17 for *all* individual taxpayers; and
- New tax rates at 7.5% for basic rate taxpayers, 32.5% for higher rate taxpayers and 38.1% for additional rate taxpayers now apply to dividend income in excess of the new allowance.

These changes are primarily aimed at preventing the avoidance of tax by individuals who are shareholders/directors of a private company and who draw remuneration by way of dividend. However, they also apply equally to the "ordinary" investor who enjoys dividend income from his/her investments.

The way in which these new measures impact on an investor depends firstly on the status of the individual concerned and then that person's individual tax position. Individuals in this context will be either an individual, a trustee or an owner/director of a private company.

(a) Individual investors

Whether an individual investor will be better off as a result of these changes depends on the rate of tax that the investor is likely to pay on the dividend income.

From the viewpoint of an investor whose marginal rate of tax exceeds the basic rate, the £5,000 dividend allowance is very generous:

- For a **higher rate** taxpayer, the allowance represents a saving of up to £1,250 (previously £5,000 @ 25% on the net dividend). To end up with a bigger overall tax bill on their dividends, the 40% taxpayer would need to receive total net dividends (ie not grossed up) of over £21,667.

- For an **additional rate** taxpayer, the corresponding figures are £1,528 and £25,250.

The investors worst affected – although there will be few – are basic rate taxpayers with dividend income above £5,000. Previously they paid no tax until they hit the higher rate threshold whereas, since 2016/17, they will pay 7.5% tax on dividend income that exceeds the £5,000 allowance.

One important point to note on this is the fact that it is the total dividend income of an investor that is taken into account in determining an investor's income for the purpose of the high income child benefit tax charge, standard personal allowances and adjusted income for pension tax relief and even to determine whether an individual is a higher rate taxpayer. Consider the circumstances of Joe.

**Example - Joe**

Joe has earnings of £38,000 before the deduction of his personal allowance in 2016/17. He also has dividend income of £10,000. The higher rate tax threshold in 2016/17 is £43,000.

How are Joe's dividends taxed?

Logically, one would expect to deduct the £5,000 allowance from £10,000 so Joe's total taxable income would fall within basic rate tax and there is tax of 7.5% (basic rate) on £5,000.

But it doesn't work like that. The way tax is calculated is to take Joe's total taxable income as £48,000. The £5,000 allowance comes off the dividend income at the bottom end (£38,000 to £43,000) leaving the £5,000 from £43,000 to £48,000 subject to higher rate tax at 32.5%.

***Planning Point:*** The new dividend allowance means that, regardless of their tax rates, a married couple can receive up to £10,000 of dividend income with no tax liability, provided that they share their dividends equally. They may wish to consider transfers of their investment portfolio to achieve this.

(b) Trustees

There is no £5,000 dividend allowance for trusts, the 10% dividend tax credit has disappeared and the dividend rate for trusts matches the individual additional rate of 38.1%. Dividend income that falls within the trustee's £1,000 standard rate band is taxed at 7.5%.

As far as interest in possession trusts are concerned, income is taxable on the income beneficiary and retains its source character as dividend/savings income etc. Therefore the comments for individual investors in (a) above basically apply.

For other trusts, typically discretionary (excluding those for vulnerable beneficiaries) that can be liable to the additional rate of tax, (assuming that the £1,000 standard rate band has been exhausted by other trust income) the trustees' net of tax income from dividends has increased as follows:-

| | **2015/16** | **2016/17** |
|---|---|---|
| | **£** | **£** |
| **Dividend** | 90.00 | 90.00 |
| **Tax credit** | 10.00 | - |
| **Taxable** | 100.00 | 90.00 |
| **Tax liability** | -37.50 | -34.29 |
| **Net income to trust** | **52.50** | **55.71** |

However, despite this, where net dividend income is distributed to a beneficiary, the beneficiary will be broadly in the same position in 2016/17 as he/she was in 2015/16. Of course, all taxpaying beneficiaries lose out because the net dividend paid to the trust effectively becomes transformed into gross non-dividend income (ie trust income) in the beneficiary's hands so this income cannot be covered by the £5,000 tax free dividend allowance.

Many trustees will accumulate dividend income and those trustees may now be even more inclined to invest in tax-sheltered investments. For example, a single premium bond is a non-income producing investment and so will avoid the higher rates of income tax on dividend

payments. Also, tax-deferred access is available via the 5% annual withdrawal facility which will be useful as a method of raising cash to pay to a beneficiary with no or little income tax liability.

(c) Shareholder/Director of a private company

For a higher rate shareholder/director taxpayer, who has his/her full dividend allowance available, drawing dividends is more attractive than paying a bonus. Indeed, if the dividend is below £21,667 this will be taxed in an even more favourable way than in 2015/16.

However, whether the shareholder/director will benefit will depend on the level of dividend payment. Dividends of more than £21,667 will put the director/shareholder in a worse position in 2016/17 than in 2015/16. So, for example, where a shareholder is taking earnings of £8,000 and a dividend of £140,000 he/she will be more than £6,000 worse off in 2016/17.

So, the tax benefits of paying remuneration from a private company by way of dividends has been reduced. These people should therefore give more thought to the payment of remuneration by way of contributions to pensions which will involve no tax cost for the director/shareholder.

**1.5 USING TAX-EFFICIENT INVESTMENTS**

It is important that those people who pay the higher or additional rate of income tax should invest in the most tax-efficient way possible.

*(a) ISAs*

The ISA is still the main method of investing savings with freedom from income tax and capital gains tax (CGT) without giving up the flexibility of access to the investment.

The annual contribution limit for 2016/17 is £15,240. The contribution can be split between the cash and stocks and shares elements as the investor chooses. This means a couple could, between them, invest £30,480. A child aged 16 or over can invest £15,240 in a cash ISA in this tax year.

Two years ago the government introduced a provision whereby a widow/widower can inherit an additional ISA allowance from their deceased spouse equal to the value of the deceased's ISA on death. They can, in addition, continue to pay contributions to their own ISA.

Naturally, no tax relief applies on an investment to an ISA but income and capital gains are free of tax. For savers who have little or no other dividend income (and so all dividend income falls within their £5,000 allowance), the ISA offers no income tax advantage. For those whose dividend income could exceed £5,000, tax freedom on dividend income within the ISA will save tax at 7.5%, 32.5% or 38.1% as appropriate. Capital gains are also free of CGT inside an ISA.

The annual contribution limit for an ISA will increase to £20,000 in 2017/18. However, it is not possible to catch up on unused allowances in later years and so, if at all possible, investors should pay as much as they can to ISAs in the current year.

*(b) Junior ISAs*

The Junior ISA (JISA) is available to any UK resident child, under age 18, who does not have a Child Trust Fund (CTF) account. The key points about JISAs are:

- There is no government contribution, but any individual may contribute.
- The maximum overall contribution in 2016/17 is £4,080 (and will increase to £4,128 in 2017/18).
- The JISA has two investment elements – cash and stocks and shares. There are no restrictions on how a contribution has to be split between the two.
- Withdrawals before age 18 are only allowed in very restricted circumstances eg terminal illness.
- The tax benefits are the same as for ISAs.

Because JISAs work on a tax year basis, unlike CTFs which are based on a one year basis linked to the child's date of birth, if there is a desire to maximise contributions to a JISA this means investing before 6 April 2017.

Children with a CTF do not qualify for a JISA but, given its tax free status, consideration should still be given to paying further contributions to that CTF or transfer the CTF to a JISA.

For those who are unhappy that the JISA will be transferred into the outright ownership of the child at age 18, alternative tax-efficient methods of investing, eg through an offshore investment bond or through collectives held in an appropriate trust, may be, with advice, worth considering.

*(c) Growth-oriented unit trusts/OEICs*

Collectives can be an ideal way for an individual to generate dividends and/or savings income to use his/her £5,000 dividend allowance and/or £1,000/£500 personal savings allowance. This is because collectives avoid the risks of investing in just one or two individual shares.

For those whose income exceeds the dividend allowance or personal savings allowance, it can make tax sense to invest for capital growth as opposed to income.

Income (dividends and interest) on collectives is taxable – even if accumulated – so if this can be limited so can any tax charge on the investment. For these people, if emphasis is put on

investing for capital growth, not only will there be no tax on gains accrued or realised by the fund managers, it should also be possible to make use of the investor's annual CGT exemption (currently £11,100) on later encashment (or both annual CGT exemptions for couples).

As for all financial planning, a careful balance needs to be struck between investment appropriateness and tax effectiveness. While performance through capital growth is obviously tax attractive, reliance on growth at the expense of income can introduce (possibly unacceptable) risk.

*(d) Single premium investment bonds*

Single premium investment bonds can deliver valuable tax deferment for a higher/additional rate taxpayer, especially so when the underlying investments are income-producing. This is because no taxable income arises for the investor during the "accumulation period". In particular, it should be borne in mind that any UK dividend income accumulates without corporation tax within a UK insurance company's internal investment funds. Capital gains (after indexation allowance) realised by the UK life fund suffer corporation tax at 20%.

The investor will receive a basic rate tax credit for deemed taxation in a UK bond fund (even though none may have occurred) meaning that, on eventual encashment, a tax charge will only arise if the investor (after top-slicing relief) is then a higher rate or additional rate taxpayer.

Ways in which this tax charge may be mitigated involve the following strategies:-

(i) Deferring the encashment of the bond until a tax year in which the investor is a basic rate taxpayer – say after retirement. In the meantime, if cash is required, the investor can use the 5% tax-deferred annual withdrawal facility.

(ii) Assigning the bond to an adult basic rate or non-taxpaying relative (say spouse or child) before encashment; the assignment will not trigger a tax charge and tax should be avoided on subsequent encashment.

More tax efficiency at fund level can be achieved via an offshore bond because there is no internal tax charge on investment growth. However, there is then no tax credit for an investor. Whether a UK or offshore bond is best for any particular investor will depend on all the circumstances of the investor; and advisers should be sure to adequately document the reasons for their product wrapper selection for each client.

*(e) Enterprise Investment Scheme (EIS)*

The EIS offers tax relief on an investment in new shares of an unquoted trading company which satisfies certain conditions. For tax year 2016/17 an investment of up to £1 million can be made to secure income tax relief at up to 30%, with relief being restricted to the amount of income tax otherwise payable. In order to speed up relief, it may be possible to elect to carry back up to

100% of the investment to the previous tax year. Unlimited CGT tax deferral relief is also available on an investment in an EIS provided some of the EIS investment potentially qualifies for income tax relief.

*(f) Venture Capital Trust (VCT)*

The VCT offers income tax relief for tax year 2016/17 at up to 30% for an investment of up to £200,000 in new shares, with relief being restricted to the amount of income tax otherwise payable. There is no ability to defer CGT as with an EIS investment but dividends and capital gains generated on amounts invested within the annual subscription limit are tax free.

*For the EIS and the VCT it is essential that would-be investors are aware of the likely greater investment risk and lower liquidity that will have to be accepted in return for the attractive tax reliefs.*

## 2. CAPITAL GAINS TAX

Five very effective forms of CGT planning are:

- use of the CGT annual exemption (which cannot be carried forward and so otherwise will be lost);
- use of independent taxation planning strategies by married couples;
- for those approaching or paying higher rate income tax, to take action so as to reduce the tax rate that applies to a gain. This can be achieved by the payment of a pension contribution;
- use of loss relief strategies; and
- CGT deferral

*(1) Using the CGT annual exemption*

Taxable capital gains are added to the investor's other taxable income to determine the rate of CGT they pay. To the extent they fall within their basic rate tax band they are taxed at 10%. To the extent they exceed it, they are taxed at 20%. Capital gains linked to residential property are, however, still taxed at 18% and 28% (as appropriate).

The annual exemption is deducted before determining taxable capital gains. For individuals the annual exempt amount is £11,100 for 2016/17 and £5,550 for most trustees. For higher and additional rate taxpayers, who will otherwise pay CGT at 20%, use of the annual exemption in

2016/17 can save up to £2,220 in tax. For a basic rate taxpayer the tax saving is worth up to £1,110.

As far as possible it is important to use the annual exemption each tax year because, if unused, it cannot be carried forward. If the annual exemption is not systematically used an individual is more likely to reach a point where some of his/her gains are subject to CGT. In using the CGT annual exemption, unfortunately a gain cannot simply be crystallised by selling and then repurchasing an investment – the so-called bed-and-breakfast planning - as the disposer must not personally reacquire the same investment within 30 days of disposal. However, there are other ways of achieving similar results:

- *Bed-and-ISA.* An investment can be sold, eg. shares in an OEIC, and bought back immediately within a tax free ISA. For 2016/17 the maximum ISA investment is £15,240. This increases to £20,000 in 2017/18.

- *Bed-and-SIPP.* Here the cash realised on sale of the investment is used to make a contribution to a self-invested personal pension (SIPP) which then reinvests in the original investment. 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 a person's earned income and other pension contributions.

- *Bed-and-spouse.* One spouse can sell an investment and the other spouse can buy the same investment without falling foul of the rules against bed-and-breakfasting. However, the sale of the investment cannot be to the other spouse – the two transactions must be separate.

- *Bed-and-something similar.* Many funds have similar investment objectives or, in the case of tracker funds, identical objectives. So, for example, if somebody sells the ABC UK Tracker fund and buys the XYZ UK Index fund, the nature of the investment and the underlying shareholdings may not change at all, but because the fund providers are different the transactions will not be caught by the rules against bed-and-breakfasting.

*(2) Independent taxation planning*

The value of the annual CGT exemption depends on whether the individual is a higher/additional rate taxpayer or not. Because the rate of CGT is 20% for a higher/additional rate taxpayer, the maximum value of the annual CGT exemption is currently £2,220.

It therefore makes even more tax sense for an individual, who is a higher/additional rate taxpayer, to transfer assets into their spouse's name to utilise that spouse's annual exemption on subsequent disposal. This will mean that, between them, the spouses can release capital gains of £22,200 each year with no CGT. This can be achieved by an outright and unconditional lifetime transfer from one spouse to the other. This should not give rise to any inheritance tax consequences or CGT implications (provided the spouses are living together).

Indeed, it may even be worthwhile transferring an asset showing a gain of more than £11,100 if the asset is to be sold as the result would be for the surplus capital gain to be taxed at 10% rather than 20%.

In transactions which involve the transfer of an asset showing a loss to a spouse who owns other assets showing a gain, care should be taken over the CGT anti-avoidance rules that apply (if any money/assets return to the original owner of the asset showing the loss).

*(3) Pension contribution to reduce the tax on the capital gain*

Some people who are realising a taxable gain may have an amount of taxable income equal to around the basic rate limit. This means that a significant part of any taxable capital gains is likely to suffer CGT at a rate of 20%. By taking action to increase the basic rate limit, it is possible for such a person to save CGT. One method of achieving this is to pay a contribution to a registered pension scheme whereby the basic rate tax band is increased by the gross pension contribution.

*(4) Loss relief strategies*

In calculating taxable capital gains for a tax year, the taxpayer will first deduct losses of that tax year, then the CGT annual exempt amount and this will leave the gains for the tax year that are subject to tax. Loss relief can therefore be important, particularly for individuals who are higher/additional rate taxpayers and so pay CGT at 20%.

In this respect the rules for losses depend on whether the individual has a carried forward loss (arising from excess losses in previous tax years) or a loss from the same tax year as that in which the gain arises.

(a) Carried forward losses

Where the loss is a carried forward loss it is only necessary to reduce the taxable gain by an amount that leaves the CGT annual exempt amount intact.

(b) Same-year losses

Losses that arise in the same tax year as capital gains are fully netted off against those capital gains to bring them down to zero. Excess losses will then become carried forward losses. In circumstances where the individual is realising losses in the same tax year as gains, he/she therefore needs to be careful not to cause a part or all of his/her annual CGT exemption to be lost in the tax year in question.

*(5) CGT deferral*

If a person is contemplating making a disposal in the near future which will trigger a capital gain in excess of £11,100 it may be worthwhile, if possible, spreading the disposal across two tax years to enable use to be made of two annual exemptions. Alternatively, if the disposal cannot be spread or the gain is very substantial, the disposal could be deferred until after 5 April 2017 to defer the payment of CGT until 31 January 2019.

## 3. PENSIONS

The 2015 Sumer Budget restricted pension tax relief in two ways:-

- Since 6 April 2016 taper relief has applied which means that the annual allowance for high-income individuals gradually reduces from £40,000 (for those with adjusted income in excess of £150,000) to £10,000 (for those with adjusted income of £210,000 plus).

- Since 6 April 2016, the lifetime allowance has reduced from £1.25 million to £1 million.

### *(1) Cut back in annual allowance*

Since 6 April 2016, where a person has adjusted income of more than £150,000, their allowable level of contribution or accrual in a registered pension scheme is reduced by £1 for every £2 of excess income. Somebody with income of £210,000 or more (and "threshold income" of at least £110,000 – see below) will only be able to make a tax relievable contribution of £10,000.

For these purposes the test will therefore be to see if an individual's adjusted income exceeds £150,000. Adjusted income is their net income (before deducting individual pension contributions) and includes the value of any employer pension contributions made by or on behalf of the individual.

It will therefore be apparent that a person may be subject to these provisions if, for example, he/she has income of £130,000 and a pension provision of more than £20,000 is made for him/her direct or via an employer contribution in a particular tax year.

This could cause some concern for people who have income that hovers around £110,000 whose employers intend to make substantial pension provision – possibly by paying a contribution to make use of the unused relief for previous years.

To cover such situations, the rules provide that for the taper to apply the individual must have a threshold income of at least £110,000. People whose income falls below the threshold income level will not be subject to the new tapering provisions. Pension contributions can be deducted to determine threshold income (although salary sacrifice arrangements set up after 8 July 2015 will be caught as will earlier salary sacrifice arrangements that require the individual to make an annual declaration).

For those affected, the loss of pension relief combined with income tax on benefit withdrawals of up to 45% can result in a very high marginal rate of income tax. However, despite possibly being caught by the new taper rules, these provisions only apply for 2016/17 onwards. For previous tax years all individuals would have been entitled to the normal £40,000 annual allowance. This could mean that individuals caught by the taper relief could pay the maximum for 2016/17 and then make contributions in respect of unused relief.

Subject to not exceeding the lifetime allowance (see (3) below) it therefore makes sense for individuals who are affected by these changes to:

- pay the maximum contribution for this tax year, which will depend on their adjusted income in 2016/17, but not be less than £10,000 and

- pay a contribution in respect of any carried forward relief for tax years 2015/16, 2014/15 and 2013/14.

We now look at this in more detail:

**Carry forward relief**

The payment of contributions in respect of carry forward relief is an important consideration for higher/additional rate taxpayers. Whilst an individual can only pay and get tax relief on contributions on up to the annual allowance, which was £40,000 in 2015/16, provided the individual has been a member of a plan for the previous 3 years and the full allowance was not used in those years, a contribution can be paid in the current year for the previous years. This is known as “carry forward” and, when calculating carry forward, the annual allowance that applied in that particular year is used eg. £40,000 for tax year 2015/16 (although special rules can apply) and £50,000 for each of tax years 2014/15 and 2013/14. Two important points in relation to the payments of contributions in respect of carry forward relief are that:-

- the individual must fully extinguish the current year's allowance before accessing carry forward from a previous tax year, and

- where the individual is making the contribution, rather than the employer, the individual must have relevant UK earnings at least equal to the grossed-up contribution that is being paid.

**Example – Janet**

Janet is self-employed. She has adjusted income of £160,000 in 2016/17, £150,000 of which is relevant UK earnings. Her annual pension allowance for 2016/17 is therefore £35,000. She has not yet made any pension contributions in this tax year. She wants to maximise her pension contributions in this tax year. In the last three years she has made a (grossed-up) contribution of

£35,000 on 1 September of each year. She therefore has unused relief of £5,000 for each of 2015/16 and 2014/15 and £15,000 for 2013/14.

So, for example, if Janet makes a contribution of £60,000 in 2016/17 this will:-

- use her £35,000 annual allowance for 2016/17;
- use £15,000 of unused relief from 2013/14, £5,000 of unused relief from 2014/15 and £5,000 of unused relief from 2015/16.

Another good reason for maximising pension contributions now is the risk that the Government will announce a reduction or removal of tax relief on pensions in their March 2017 Budget – something that many commentators expect, given that in one of their Autumn Statement documents, the Government flagged up that the cost of pensions tax relief was '*one of the most expensive sets of relief offered by the Government. In 2014/15 this cost around £48 bn with two thirds of the tax relief going to higher rate and additional rate taxpayers'.*

***(2) People affected by the Money Purchase Annual Allowance***

In the Autumn Statement, the Government announced the reduction of the Money Purchase Annual Allowance (MPAA) from £10,000 to £4,000 with effect from 6th April 2017. They are consulting on the details of this. The MPAA is triggered by one of a list of events, for example drawing income from flexi-access drawdown, taking a UFPLS, establishing a scheme pension from a SSAS or by purchasing a flexibly annuity.

The reason behind this reduction is probably that the Government feel that the MPAA system is being abused because an individual can invest £10,000, receive tax relief on the full amount of, say, £4,000 and then withdraw the £10,000 whilst only paying income tax on 75% of that amount.

This new restriction will not apply to all people.

For example:-

- those who only draw tax free cash from their pension
- those who draw benefits in the form of an annuity
- those who can draw benefits by encashing small pension pots of up to £10,000 each or
- those who are in (pre April 2015) capped drawdown arrangements.

For those others who will be affected by this reduction, they should pay the current £10,000 permitted contribution while they still can!

***(3) Reduction in the lifetime allowance***

Individuals, who are or are likely to be affected by the reduction in the lifetime allowance from £1.25 million to £1 million which applies from 6 April 2016, will need to consider what action they should take. Action may still be possible to preserve a higher entitlement for those people who have not paid any further contributions since 5 April 2016 or whose benefits are likely to have a value of between £1 million and £1.25 million on retirement.

For others thought needs to be given as to whether they might be caught. Don't forget that these new rules could, of course, extend to people who have pension benefits some way short of £1 million but who have some years to retirement over which reasonable investment growth could be expected. It could also apply to those with pensions that commenced pre 6 April 2006 who have since that date taken out further pension arrangements that have yet to be tested against the lifetime allowance.

Where people feel that they do not want to make further provision via a registered pension scheme because of the imposition of the lifetime allowance, but still need to save for retirement, they should use tax-efficient investments outside of a pension wrapper. Savings, such as ISAs, collectives and single premium bonds, should all be considered.

## 4. INHERITANCE TAX

*1. Inheritance tax – the current position*

Whilst the new residence nil rate band of £100,000 per person (from 2017/18) rising to £175,000 per person (from 2020/21) may provide some respite from potential inheritance tax (IHT) liabilities for some people remember that:

- this only applies on deaths occurring after 5 April 2017

- it will not help people whose estate exceeds £2.35 million (£2.7 million on the second death)

The IHT nil rate band has been frozen at £325,000 for 2016/17 and will remain at this level until April 2021. Because of increasing house prices and investment values; and the freezing of the nil rate band, once again the amount of inheritance tax collected by HMRC is increasing to substantial levels. People whose estates may be affected should therefore take early action.

**Planning**

In advance of the year end, individuals who wish to transfer wealth on to the next generation should consider making full use of their £3,000 annual exemption. If this was not fully used in the last tax year (2015/16), it can be used now provided the donor first fully uses their annual exemption for this tax year (2016/17). So for somebody who has made no gifts, they can make gifts of £6,000 within their annual exemptions now.

For those who have income that is surplus to their needs, it may also be appropriate to establish arrangements whereby regular gifts can be made out of income in order to utilise the normal expenditure out of income exemption. An ideal way of achieving this is to pay premiums into a whole of life policy in trust to provide for any IHT liability.

The year end is also a good time to generally consider a client's IHT position with a view to making larger gifts. Where ongoing control of the assets gifted is required, a discretionary trust will be useful but care needs to be exercised so as not to exceed the available nil rate band. If the investor needs access to cash from the trust and IHT efficiency, a loan trust or discounted gift trust should be considered.

*2. Inheritance tax and non-domiciled persons*

The government proposes to introduce new tax legislation to ensure that, from April 2017, inheritance tax is payable on all UK residential property owned by non-domiciliaries, regardless of their residence status for tax purposes, including property held indirectly through an offshore structure such as a trust or company.

From April 2017 the point at which a non-domiciled individual is deemed to be UK domiciled will be reduced from 17 out of the last 20 tax years to 15 out of the last 20 tax years. Furthermore, this test will then apply for inheritance tax, capital gains tax and income tax purposes.

**Planning**

Individuals who will be affected by these new rules need to take advice and take action before 6 April 2017. For example, those who are non-UK domiciled but have been resident in the UK for 15 or 16 tax years may wish to establish an excluded property trust before the new rules are introduced. Also there will be a relief whereby, for CGT purposes, individuals can rebase assets at their value at 6 April 2017, if they owned them in July 2015 and have previously elected for the remittance basis charge. Also, the Government proposes to allow all non-domiciliaries to "unmix" income, gains, offshore income gains and capital in overseas bank accounts. The detail of this proposal is particularly eagerly awaited. Planning before 6 April 2017 may be appropriate. Clients should consult a specialist in this area.

## 5. BUSINESS TAXATION

Given the relatively low rate of corporation tax at 20% as compared to the higher rates of income tax (possibly 45%), if personal cash is not needed it has made sense for shareholder/directors of private limited companies to keep profits inside the company at the moment rather than distribute them as dividends or remuneration. (This is particularly so as the Government have confirmed that they do intend there to be a 17% corporation tax rate in 2020). A distribution to a director/shareholder could then be made as and when income tax rates reduce. Given the National Insurance contribution advantages, when it is desired to pay cash out of the company it is likely that a dividend will be the most attractive method of extraction.

On the other hand, if the intention is to retain the profits in the company indefinitely, care should be taken that these retained amounts do not prejudice entitlement to CGT entrepreneurs' relief on a later sale of the shares in the company. This can usually be achieved by appropriate advance planning and, especially, by avoiding the investment of these funds. Reinvestment in the business should, however, not cause a problem in relation to entrepreneurs' relief. Specialist advice so as not to put this potentially valuable relief at risk is essential.

It should be noted that, given the disparity in the rates of corporation tax and income tax, the Government is reviewing the whole area of how cash retained in a company should be taxed and we may see substantial changes announced in this area in the Budget.