



Higher Tax Rate and Pension Changes for 2009/10 Summary and Tax Strategies

Higher Rate Band - There is a new 50% income tax rate on income exceeding £150,000 from 6 April 2010. Coupled with national insurance increases from 6 April 2011, the new highest tax rate of 51.5% will be suffered by employees.

Also from 6 April 2010, there will be three rates of tax on dividend income. Where income falls within the basic rate band, the 10% tax credit will extinguish any liability, as before. The equivalent rate for 40% taxpayers remains at 32.5% but a new rate, where income would be taxed at 50%, of 42.5% will be introduced.

In addition to high earners, the additional rate of tax for trusts will also rise to 50% with a new higher trust rate of tax on dividends of 42.5%.

On top of the rate hike any basic personal allowance will be reduced by up to 100%, at the rate of £1 for every £2 of income above £100,000. Based on the current personal allowance of £6,475, this would mean the full allowance would be extinguished at an income level of £112,950. This change also takes effect from 6 April 2010.

The income referred to is 'adjusted net income', which allows for certain valuable deductions against income, such as trading losses, gross pension contributions and gift aid payments, and adds back certain reliefs claimed for payments made to trade unions or police organisations.

The gradual tapering of the allowance where income falls within the narrow banding of £100,000 to £112,950 means that, where income falls within these limits, the effective rate of income tax is up to **60%**. If this is earned income, a national insurance charge of 1%, rising to 1.5% from April 2011 will also be charged.

Tax relief on pension contributions cut for high earners

A further blow for higher earners is the announcement of a restriction on the availability of higher rate tax relief on pension contributions with effect from 6 April 2011, for individuals with taxable income in excess of £150,000.

Currently, tax relief at up to 40% is available for pension savings up to a maximum of 100% of net relevant earnings, or is capped at the annual allowance amount (£245,000 for 2009/10) when paid by the employer. The amount of relief available will be tapered for individuals earning between £150,000 and £180,000, progressively reducing it from 50% (the new higher rate tax rate for individuals earning over £150,000) down to 20%. i.e. with only basic rate relief available where income exceeds £180,000.

Anti-avoidance rules

In order to prevent certain individuals from taking advantage of the delayed introduction of the new rules, the Government has also announced an anti-forestalling provision which will limit relief for contributions made in the 2009/10 and 2010/11 tax years.

Individuals with incomes of £150,000 or more, who change their normal pattern of regular pension contributions after 22 April 2009 (Budget Day) may be affected where their total pension regular contributions in a tax year (inclusive of contributions made by their employer or third party) exceed £20,000.

These changes have effectively capped the amount on which you can get higher rate relief to £20,000 unless you were already making regular contributions of more than that.

One of the problems with the original proposals was that 'regular' was defined as being paid quarterly or more frequently. As a result many, such as the self employed, who paid annual contributions stood to lose out. It seems that the Government has listened to representations and moved their position a little. The Finance Bill was amended before it received the Royal Assent so that, for infrequent contributions (i.e. less than quarterly), an average over the last three tax years can be used, subject to a cap of £30,000 instead of £20,000.

For those who breach these funding limits, a tax charge will be levied and collected through their self-assessment tax return. The charge will equate to 20% of 'additional' contributions made in excess of the special annual allowance.

The tax charge will not apply to any normal, regular ongoing pension savings, that were in place before 22 April 2009, whatever their value. Any increases in contributions/scheme benefits over a normal pattern made between 6 April and 22 April 2009 should not be subject to the charge.

Income, when assessing whether the £150,000 limit has been breached, includes most sources of income, including earnings, savings income, dividends and income from property.

Some Good Mitigation Strategies

The following suggestions can be used to reduce taxable income and also have the added bonus of CGT mitigation.

Enterprise Investment Scheme (EIS) Relief

There are five current EIS tax reliefs:

Income tax relief - Provided an EIS qualifying investment is held for no less than three years an individual can reduce their income tax liability by an amount equal to 20% of the amount invested. The minimum subscription is £500 per company and the maximum per investor is £500,000 per annum.

Individuals may now also elect to treat their subscription for EIS shares, up to their maximum annual allowance, as if made in the previous tax year, thereby carrying income tax relief back one year.

CGT Deferral Relief - Tax on gains realised on a different asset can be deferred indefinitely, where disposal of that asset was less than 36 months before the EIS investment or less than 12 months after it. Deferral relief is unlimited, in other words, this relief is not limited to investments of £500,000 per annum.

CGT Freedom - No Capital Gains Tax is payable on the disposal of shares after three years provided the EIS initial income tax relief was given and not withdrawn on those shares.

Loss Relief - If EIS shares are disposed of at any time at a loss (after taking into account income tax relief), such loss can be offset against the investor's capital gains or income in the year of disposal or the previous year. For gains offset against income tax, the net effect is to limit the investment exposure to 48p in the £1 for a 40% tax payer if the investor realises a total loss. Alternatively, the losses can be offset against Capital Gains Tax at the prevailing rate - 18% from tax year 2008/09.

Inheritance Tax Exemption - EIS investments, as they are in qualifying trading companies, are generally exempt from Inheritance Tax after two years of holding such investment.

Venture Capital Trusts

Investments of up to £200,000 in **Venture Capital Trusts** (VCTs) offer significant tax incentives to investors including 30% income tax relief.

Tax Breaks - VCTs are quoted limited companies whose purpose is to invest shareholders' funds in smaller unquoted trading companies, (including AIM listed stocks) having potential for growth, with a view to making profits. Most VCTs are run by investment managers and raise their funds from private investors.

Individuals may be able to secure a number of tax advantages from this sort of investment. However, from 6 April 2006, shares in VCTs must be held for at least five years (previously three years) to obtain all the potential tax benefits. In addition, the individual must be 18 years of age or more on the date of issue of the shares.

The tax relief is due when the shares are issued and can be given by an adjustment to the PAYE coding, or a claim in the tax return.

Tax relief will not be given on VCT investments where the shares were not acquired for bona fide commercial reasons, and the shares need to be held for 5 years. The tax reliefs set out below are available to individuals aged 18 or over and not to trustees, companies or others who invest in VCTs. Whilst there is no specific limit on the amount of an individual's acquisition of shares in a VCT, tax reliefs will only be given to the extent that the total of an individual's subscriptions or other acquisitions of shares in VCTs in any tax year do not exceed £200,000.

Income tax relief - 30% of the amount subscribed for shares issued in tax year 2009/10, provided that the shares are held for at least five years.

The income tax relief at 30% is available to be set against any income tax liability that is due in the year of subscription, whether at the lower, basic or higher rate. However, tax relief will be limited to the amount which reduces the investor's income tax liability to nil. The amount of VCT income tax relief claimable by an investor could be reduced by any other transaction that effectively benefits from income tax relief, such as a pension contribution or gift aid payment, as both result in an automatic reclaim of basic rate tax by either the pension provider or respective charity. Tax credits on dividends are not repayable, and investors should take this into account when considering their investment in a VCT.

Tax-free dividends - Exemption from income tax on dividends from shares in VCTs. Profits made by a VCT on the disposal of investments are not subject to tax and can be paid out as tax-free dividends to shareholders in the VCT.

CGT freedom - Capital gains realised on disposals of shares in VCTs are tax-free. However, losses realised on disposals of shares in VCTs cannot be used to offset capital gains.

Individuals will not be liable to Capital Gains Tax on any profits arising from the disposal of VCT shares unless the VCT Company is no longer a trust, i.e. they are taken over by a non-VCT. CGT on gains that were deferred when investing in VCT shares before 6 April 2004 will still be due. (CGT deferral relief is no longer available on investments in VCT shares made on or after 6 April 2004).

This fact sheet has been prepared for general guidance only and should not be acted upon without specific advice. Please contact us if you require further information. Created July 2009

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