

# **The Origen Financial Services Guide for Higher Earners 2012/13**

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Tax planning and pension savings

Issues and considerations

Updated for the Chancellor's Autumn Statement November 2011

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## 1.0 Introduction

The tax year 2010/2011 saw the introduction of a number of measures to enable the Government to raise revenue in order to balance the public accounts. This included the restriction on personal allowances and the introduction of an additional tax rate of 50%. They had already introduced measures for restricting tax relief on pension savings for high earners (typically those with incomes from all sources in excess of £130,000) and to prevent abuse of the current legislation, anti-forestalling measures applied to prevent individuals from benefiting from higher rate relief on large increases to contributions prior to April 2011.

A change of Government brought with it a change in emphasis and an arguably simpler approach to the issue but the measures that became effective from 2011/2012 affect all those who have pension savings, not just high earners. That said, those with higher incomes remain more directly in the sights of HM Revenue & Customs (HMRC).

The onus of responsibility for ensuring you are not exceeding the new specified limits still rests with the individual (and not with your employers). It is important therefore that you seek professional help and advice in ensuring you maximise – but more importantly do not exceed - the proposed annual limits.

## 2.0 Tax planning

### Income Tax Rates

- For individuals, from 6 April 2011 all income over £150,000 is taxed at 50%, except dividend income which suffers tax at 42.5%, (the higher rate liability being effectively 36.1% of the net dividend received).
- The £100k+ earnings trap: In addition those with 'adjusted net income' over £100,000 are restricted in their basic personal allowance (up to £8,105 from 6<sup>th</sup> April 2012) with the allowance being removed completely where that income exceeds £114,950 (£116,210 from 6<sup>th</sup> April 2012, restricted by £1 for every £2 above the £100k threshold). Whilst the additional rate of income tax is 50%, the effective rate on income falling within the band between £100,000 and £114,950 is actually 60%.
- Though the personal allowance was increased by £1,000, the threshold between the basic and higher rate tax bands was reduced to £35,000, so higher rate tax for most people commences when income exceeds £42,475, whereas it was £43,875 for the 2010/2011 tax year. The same principle will apply in 2012, where the increase in the standard personal allowance is to be offset by a reduction in the basic rate band from £35,000 to £34,370. Higher rate tax will therefore still "kick in" when income exceeds £42,475.
- Employee rates of Contracted in Class 1 National Insurance Contributions increased to 12% with the additional rate for earnings over the Upper Earnings Limit increasing to 2%. For 2012/2013 the employees' Class 1 Primary Threshold has been increased to £146 per week and the Upper Earnings Limit remains at £817. The employer's Secondary Threshold increases to £144 per week.
- Many trusts, subject to the income tax rate applicable to trustees, continue to suffer 50% tax on all accumulated non-dividend income (42.5% on dividends). The standard rate still currently applies to the first £1,000 of income.

### Examples

Taxable earnings	£120,000.00		£130,000.00		£150,000.00		£170,000.00	
	2011/2012	2012/2013	2011/2012	2012/2013	2011/2012	2012/2013	2011/2012	2012/2013
<b>Income Tax</b>	£41,000.00	£41,126.00	£45,000.00	£45,126.00	£53,000.00	£53,126.00	£63,000.00	£63,126.00
<b>National Insurance</b>	£5,781.00	£5,737.00	£5,981.00	£5,937.00	£6,381.00	£6,337.00	£6,781.00	£6,737.00
<b>Total "tax"</b>	£46,781.00	£46,963.00	£50,981.00	£51,063.00	£59,381.00	£59,463.00	£69,781.00	£69,863.00
<b>Increase</b>		+0.39%		+0.16%		+0.14%		+0.12%

Individuals may wish to look at ways in which they can reduce their exposure to Income Tax and National Insurance as well as tax on other savings and investment income. Detailed below are some of the key areas for consideration for high earners (for "spouse(s)" also read "registered civil partners"):

1. Equalise income between spouses. If you earn more than £100,000 and your spouse doesn't, consider transferring income producing assets – including savings accounts - outright to your spouse to use their lower rate tax bands. Similarly consider who acquires future income producing assets to ensure lower rate bands and unused allowances of your spouse and other family members are utilised. Also consider making use of all available annual allowances for capital gains tax by transferring assets between spouses, where it is appropriate to do so. Transfers between spouses are generally on a no loss no gain basis, as long as they are unconditional.
2. Review your investment portfolio. Consider holding investments that produce growth in a capital form which is therefore subject to capital gains tax (CGT), taxable gains taxed at 18% for basic rate taxpayers or 28% for others and with a tax free annual exemption, rather than income tax. The annual exemption will remain at the current level of £10,600 per individual for 2012/2013. Annual cash requirements could be met through the disposal of assets within the portfolio rather than relying on dividend income. This affects the potential for investment growth of your portfolio. As part of this review, make sure that full use is being made of your ISA (Individual Savings Account) allowances, which will increase from £10,680 to £11,280 per investor for the 2012/2013 tax year. Making use of the "bed and ISA" rules can help to move gains into a CGT free environment in appropriate circumstances.
3. Consider the use of life assurance bonds where you can currently take a 5% withdrawal, tax-deferred, each year. Depending on the underlying assets, the top rate of income tax on investments within UK life assurance bonds is 20%, less relevant expenditure. Offshore insurance bonds may still be an option for larger holdings, whether held personally or by trustees, where the underlying rate is less and the deferred rate is likely to be higher. On encashment the profits are subject to income tax so, where an encashment is appropriate, this should be a long term view in the hope that the rate of income tax on encashment might be lower in the future, than it is now.
4. If you have family trusts, review investments to take advantage of lower capital gains tax or, where appropriate, non-income producing assets.

5. Give careful consideration to your investment strategy and whether you might wish to take further risk to benefit from other investment tax reliefs, rather than just pension tax relief. Investment in a qualifying Enterprise Investment Scheme ('EIS') company or a Venture Capital Trust ('VCT') provides generous tax breaks although be clear that these are higher risk investments. 30% income tax relief is available on a qualifying EIS investment (after 6<sup>th</sup> April 2011) up to £500,000 i.e. an absolute saving of £100,000 *plus* after 3 years shares can be sold completely free of capital gains tax. Relief is available at 30% on a VCT investment up to £200,000. In addition VCT dividends are tax free and the investment can be cashed in tax free after five years. These investments are not necessarily suitable for everyone and should not be entered into without seeking independent advice (see table below for a comparison of limits and tax reliefs). In his Autumn Statement in November 2011, the Chancellor announced that the Government will introduce a new Seed Enterprise Investment Scheme (SEIS) to encourage investment in new start-up companies. SEIS will provide income tax relief of 50% for individuals who invest in shares in qualifying companies, with an annual investment limit for individuals of £100,000 and cumulative investment limit for companies of £150,000. Income tax relief will be 50% irrespective of the tax rate that the individual is paying but we expect that relief will be limited to the amount of tax that the individual is liable to pay. For example, if an individual is paying tax of £10,000 then his tax relief on a SEIS investment will be limited to the smaller of 50% of the investment or £10,000. Full details have yet to be published.
6. Make full use of tax reliefs such as charitable donations, income tax losses and capital allowances to reduce the top slice of income, whilst the 50% tax rate remains in place.
7. Ask your employer to consider implementing a share incentive scheme as part of your remuneration package, if applicable. There are a number of Government approved schemes which allow employees to benefit in the growth in value of the company at capital gains tax rates which, for high earners, will be considerably lower than the income tax payable on a cash bonus. Of course, such share investments, though potentially tax efficient, may also carry some risk.
8. Consider 'sideways loss relief', which restricts losses to a maximum of £25,000 in future and in any of the last 3 tax periods. Traditionally 'losses' are applied to certain trades with high set-up costs, which includes film production and which have usually come with the ability to borrow, therefore reducing entry costs but arguably increasing risk.
9. Be aware that anti-avoidance legislation has been introduced to combat the use of employee trusts and other vehicles in remuneration arrangements, which have proved to be very popular.

Comparison of VCT and EIS limits and tax position for investors:

	VCT	EIS
Relievable annual investment limit	£200,000	£500,000*
Income tax relief for subscribers	30%	30%
Income tax relief carry back	No	One year
Clawback if held for less than	5 years	3 years
CGT deferral relief period		
- before gain made	n/a	1 year
- after gain made	n/a	3 years
Tax free dividends?	Yes	No
Tax free capital gains?	Yes (after 5 years)	Yes (after 3 years)
Tax relief for losses?	No	Yes
IHT business property relief?	No	Yes**

\*No limit on CGT deferral

\*\*After 2 years assuming legislation does not change and EIS continues to qualify.

## 3.0 Pensions restriction of tax relief

The complex proposals put forward by the Labour Government were repealed and replaced by an arguably simpler system whereby the annual allowance has been reduced to £50,000 from 6<sup>th</sup> April 2011 onwards. In addition, from April 2012 onwards, the Lifetime Allowance is to reduce from £1.8m to £1.5m, which means that individuals who might have been expecting the Lifetime Allowance to be at least £1.8m when they reach retirement may now want to review their planning.

There is some provision for individuals to protect their pension savings up to the level of £1.8m, by way of "Fixed Protection" and those who already have Primary and/or Enhanced Protection under the former regime broadly still have that protection. There is a limited "window" during which fixed protection can be applied for as all applications, with no exceptions, must be with HM Revenue & Customs, (HMRC) on or before 5<sup>th</sup> April 2012.

There is a specific form required and there are conditions to be fulfilled if protection is to be retained. Anyone who is or feels that they may be impacted by the reduction in the Lifetime Allowance should seek advice.

Where an individual's pension savings for the input periods ending in a tax year exceed the Annual Allowance, they will be subject to an annual allowance tax charge. The amount of the tax charge will depend upon the individual's marginal tax rate but high earners may face a charge of 40% or 50% or a mixture of the two.

The annual allowance is measured by way of pension input and for defined contribution (money purchase) arrangements such as Personal Pensions, this relates to total contributions (employer and employee). In relation to defined benefit (final salary) arrangements it is the increase in accrued rights in an input period multiplied by a factor. In the past, the factor used for this purpose has been 10:1 but that became 16:1 from April 2011. So, for example –

**Mr A** is a member of a Group Personal Pension scheme operated by his employer. His employer is paying £19,500 per annum to it and he is paying £7,500 so his pension input is £27,000, leaving headroom for additional pension savings of up to £23,000 on which he can receive higher rate tax relief for the input period ending in 2011/2012.

**Miss B** is a member of her employer's final salary scheme which provides her with  $1/60^{\text{th}}$  of her final pensionable pay for each year of service. She has 25 years service and her pensionable pay at the end of last year was £130,000. At the end of this year her pensionable pay is £133,900 so her pension rights have increased from £54,167 to £58,023, an increase of £3,856. However, after adjusting the starting figure to allow for inflation at 3.1%, the increase for the purposes of the annual allowance test is £2,176.82. This is multiplied by 16 to arrive at her "deemed contribution" of £34,829, which leaves scope for further savings up to £15,170 in the 2011/2012 tax year, before she faces an annual allowance tax charge.

It is possible that an individual may have a significant increase in pension savings in a particular year that might be caused by promotion, a bonus payment or something else that results in a "spike" in their pension savings record. In these circumstances they may be able to make use of a facility to "Carry Forward" unused annual allowances from previous tax years. For example –

**Mrs C** is a member of an employer's final salary scheme within which she has accrued  $34/60^{\text{th}}$  of her pensionable pay at the start of the relevant input period. Her pensionable pay was £60,000 and the Consumer Price Index (CPI) for the period was 2.5%. Due to a promotion and bonuses, she sees an increase in her pensionable pay to £72,000.

Her pension rights have therefore increased from £34,000 to £42,000 which after adjustment for inflation gives an increase in the input period of £7,150 and a "deemed contribution" of £114,400 of which £64,400 is chargeable to tax at her marginal rate (40%). She is potentially liable to the charge even though she has not directly received the taxable sum.

In the previous three tax years, her pension input (calculated as above, using the factor of 16:1) for each year has been £25,000, £30,000 and £25,000 respectively. The annual allowance in each of those years was £50,000 and so there is a total of £70,000 in unused allowance that is available to her in the tax year in question. Her allowance for the tax year is used first and then the unused amount for each of the subsequent years is used starting with the earliest year first.

The end result is that she can use £64,400 of her unused allowance and still have headroom for additional savings of £5,600 in the relevant tax year or which can be carried forward to the next tax year. She would therefore get higher rate relief on all of her pension savings even though it was in excess of the annual allowance.

HMRC has confirmed that for the purposes of this Carry Forward aspect of the reduced annual allowance, the annual allowance for tax years 2008/2009 to 2010/2011 inclusive, will be treated as £50,000 and the 16:1 factor is to be used to value pension input in those years.

## 4.0 Planning issues

The changes outlined above bring about some specific planning issues that need to be considered both for now and after 6<sup>th</sup> April 2012.

1. Those who already have significant funds accumulated may wish to consider the impact that the reduced Lifetime Allowance might have from April 2012. Should they continue to contribute or should they look for tax efficient alternatives? This will depend upon personal circumstances, attitude to risk etc. and they should seek independent advice.
2. Individuals who have the relevant UK earnings to do so may wish to maximise pension contributions in the 2011/2012 tax year and make use of any unused annual allowance.
3. Since the annual allowance is based upon input periods ending in a tax year, some thought might be given in appropriate circumstances to closing an input period before 5<sup>th</sup> April 2012, so that assessment of the pension input is carried out in the 2011/2012 tax year so that the maximum benefit can be obtained from earlier unused annual allowances. Unused allowance for 2008/2009 may not be able to be used after 5<sup>th</sup> April 2012. This may not be possible in all cases and in any event, a pension scheme can only have one input period close in a tax year.
4. HMRC has recently clarified the manner in which the cumulative unused annual allowance for the tax years 2008/2009, 2009/2010 and 2010/2011 is calculated. It is a more favourable calculation than was generally believed to be the case and so some individuals, who might consider that they have maximised their allowance, may wish to revisit that calculation to see if there is any further scope for 2011/2012.
5. Where fixed protection is being applied for to offset the change in the Lifetime Allowance, it may be appropriate to maximise pension contributions before 5<sup>th</sup> April 2012. A condition of protection is that individuals will not be able to make contributions to money purchase schemes (such as personal pensions) and/or accrue benefits under defined benefit schemes after that date. There may be a lot of issues to consider before opting for fixed protection and waiting until the last minute is not to be recommended. Advice should be sought at the earliest opportunity.
6. Though pension planning still plays a vital role in providing an individual's future income in retirement, those who may be affected by the changes to the annual and lifetime allowances may wish to look at other options for saving which may be

outside of the environment of a registered pension scheme. This may have particular advantages where the employer offers flexible remuneration options and it is possible to redirect pension contributions to some other form of investment or savings.

7. In many cases, non-working or lower paid spouses/partners have little or no pension provision of their own. Making contributions for that person can secure tax relief at the basic rate to enhance the value of the savings and contribute to the household pension income in the future.

## 5.0 Conclusion

Raising taxes will continue to be the main mechanism to reduce the level of Government debt and though we are all currently “feeling the pain”, it is the higher paid who will be bearing the main brunt of income tax and national insurance as well as the tax on pension savings.

Whilst there are some key considerations for anyone affected by any - or all - of the above measures, a thorough review may be the most sensible action. Certainly the tax charges on pension contributions/savings can be avoided, although the benefits of tax relief on the first £50,000 of pension input still make pension planning a viable option. There are to be greater opportunities in retirement planning, with the need to secure an income at 75 being removed and death benefits on residual lump sums after age 75 falling outside of the Inheritance Tax net in future.

At Origen Financial Services we feel we are uniquely positioned to advise clients on their most suitable course of action to account for these significant changes: Origen Financial Services has been voted ‘Best Retirement Planner of the Year’ in recent awards (Source: Money Marketing Awards, 2008 and 2009) – who else better to steer you through these murky waters.

The above is based upon our understanding of current legislation, proposals contained in draft legislation and accompanying documents and the practice of HM Revenue and Customs. Legislation and the practice of HM Revenue and Customs may be subject to change.

References to ‘spouses’ above apply equally to Registered Civil Partners.

The notes are intended to be for information only and not to be taken as investment advice. Before any action (or inaction) you may take upon any of the above suggestions, individuals must seek independent advice as to the suitability and tax consequences.

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