



## What action should clients take ahead of tax changes?

**T**he new government has announced that it will be presenting its emergency Budget on June 22. Based on the individual policies of the LibDems and the Conservatives, and on the Coalition Agreement they published shortly after forming the Government, commentators expect changes to two key areas of taxation: pension contribution tax relief and capital gains. In this issue of *Wealth Management Alert* we look at what, if any, action your clients could consider taking before the Budget to mitigate the impact of these possible changes. Of course, tax considerations alone should not be the main reason for making any investment decisions – as the old saying goes, the tail should not wag the dog!

### Pension contributions

Higher rate tax relief on pension contributions may well be abolished, although relief will probably be given at the lower rate of income tax (currently 20%). This would most likely be in addition to the restrictions on tax relief for people earning £130,000 or more already introduced by the then Chancellor Alistair Darling. Clients might therefore want to consider making pension contributions up to the maximum limit before 22 June.

### Capital gains tax: personal gains

It is widely expected that capital gains tax (CGT) will be brought back in line with income tax. For high earners this could be as high as 50%. While CGT is not uppermost in many people's minds in the current economic climate, those selling investments, maybe because they are approaching retirement, and people thinking of selling a second home are among those most likely to be effected.

The consensus of opinion is that to keep things simple, the Chancellor will choose for this to take effect from the start of the next tax year, (6 April 2011). However, the possibility of the introduction of anti-forestalling measures to prevent individuals realising certain gains in advance of any possible rise has not been ruled out.

The good news is that a 'generous' entrepreneurs relief may be announced for capital gains on business assets.

### Action to consider in relation to capital gains:

- People thinking of selling assets may want to do so sooner rather than later.
- Those who have made substantial gains but who do not wish to sell their assets could consider "rebasings" them: ie sell the asset and then buy it again (although you must allow at least 30 days between the sale and purchase to avoid the "bed-and-breakfasting" rules). Any gain in excess of the annual personal CGT allowance will be taxed at the current rate of 18%.
- "Bed and ISA" may be an option for clients who have not yet used up this year's ISA allowance and have investment gains to realise. This involves selling the funds and repurchasing them within an ISA. Any future growth is then free of both income and capital gains tax.
- Rebasings provides the opportunity to redistribute family wealth, maybe as part of inheritance tax planning, or to reduce possible future tax. The current owner of the asset can sell it, realising any capital gain and paying tax at the current rate, to his or her spouse, civil partner or adult child. This can be a direct sale – there is no need to wait for 30 days – although it must be at 'arm's length', ie the seller must not retain any interest in the asset once it is sold.
- Realising gains also provides the opportunity to transfer assets into a self-invested personal pension (SIPP). This can be done "*in specie*", whereby the assets are transferred into the SIPP. Any future gains made within the SIPP are not subject to CGT. Another option is to make a contribution from earnings into the SIPP. This contribution would qualify for income tax relief. These funds could then be used to purchase the assets.
- Collective investments can be sold, realising any gain, and then repurchased within an offshore bond. Any future gains would be kept within the bond, allowing the owner to realise them when they pay less tax. However, charges need to be taken into account when considering this option.

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## Income tax

The main chance to income tax is likely to be the widely trailed increase of the personal allowance to £10,000, although it is expected that this new limit will be introduced in stages between now and 2015/2016. The 50% tax rate and reduction in personal allowance for high earners are expected to remain. With high earners about to receive their second month of pay, here are a few ways those who have not already taken action may be able to reduce the amount of income tax they pay.

The key to avoid falling into the 50% tax rate is to keep adjusted net income below £150,000, while those earning between £100,000 and £112,950 are faced with an effective marginal tax rate of 60% on this band of income, so reducing income in this band is very tax-efficient:

- Couples where one person pays income tax at a higher rate than the other should consider transferring income-producing assets to the person taxed at the lower rate.
- Consider moving to investments that pay capital rather than income, although this is likely to be of limited scope if the rate of CGT increases as expected.
- People willing to take some risk and with some money to invest could invest in Enterprise Investment Schemes (EISs) or Venture Capital Trusts (VCTs). VCTs offer immediate income tax relief of 30%, which is retained provided the investment is held for a minimum of five years. EISs offer 20% income tax relief on investment, and are exempt from CGT if held for three years or more.

## But we don't yet know! Remain focused on long-term objectives

Our view is that with reference to CGT, ultimately the most important thing is that any change in CGT must not be a disincentive to long-term investing. Additionally, if the rate of CGT is to rise, some method of making allowance for inflation must be introduced, whether indexation, taper relief or simply a rate lower than the corresponding income tax rate. It would be unfair for people to be hit by a tax on "non-real" gains and it is vital that the Government accepts this in any new rules.

## Using pension contributions and/or salary exchange to reduce net adjusted income

'Adjusted net income' is taxable income reduced by specified deductions. Examples of deductions are trading losses and payments made gross to pension schemes, grossed-up gift aid and pension contributions which have received tax relief at source. As the rules stand at time of writing, provided an individual's 'adjusted net income' is below or equal to £100,000, they will continue to be entitled to the full amount of the basic personal allowance.

Clients may be able to make pension contributions and/or use salary exchange to reduce their net adjusted income. However, for those earning more than £130,000, the anti-forestalling measures need to be taken into account. A mix of pension contributions and salary sacrifice can give the most efficient result, depending on the amounts involved and whether the individual in question has already used salary sacrifice.

This is a complex area where, with good advice and planning, high earners may be able to reduce their tax bill.

Finally, if you advise clients to take action before the Budget, ensure you make appropriate warnings. At the present time we don't know when changes will take place; we don't know what the new tax rates will be or what the allowance will be. There may be time to take mitigating action after the Budget, or there may not. Indeed, whilst it is perhaps unlikely, the changes could apply for the whole of the current tax year, meaning it is already too late. (That would be seen as unfair but the Government could do that.) It is important to deal with all these relevant points when providing advice.

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