



Tax-efficient options for high earners

Many high earners are now faced with a double whammy. Not only is the top level of income tax increasing to 50%, but also the most efficient way of reducing taxable income – making pension contributions – will be severely restricted as of April 2011. On top of this some may be approaching – or have already reached – the maximum total permitted pension fund value (lifetime allowance), which for the current tax year is £1.8 million. In this article we look at other investment options open to them for reducing their income tax bill.

ISAs

Individual Savings Accounts (ISAs) are one of the more straightforward options. Although the investment is made out of taxed income, once within an ISA any income and gains are free of both income and capital gains tax (subject to 10% tax credit on dividends received). An individual can place up to £10,200 (for the tax year ending 5 April 2011) in an equity ISA each year. This may seem low but if a couple both use their allowances each year and choose their investments wisely, they could soon build up a significant amount sheltered from future tax. A wide range of funds are available (as indeed are self-select ISAs) so there is something to suit all risk appetites.

Offshore bonds

Tax on growth and income from offshore bonds is deferred, only becoming payable when the investment is sold. It is then charged at the investor's highest marginal rate. As a result it can be an interesting option for people who expect to be in a lower tax band when they retire, or for those planning on retiring abroad and no longer subject to UK income tax. They can also be assigned to someone else, for instance a family member on a lower income tax band when the original investor does not plan to re-invest in their own name.

As with onshore bonds, 5% of the initial investment can be withdrawn each year free of income tax as it is considered to be a return of capital.

However, charges for offshore bonds can be very high and, as with all investments, it is important to select underlying funds that match the investor's attitude to risk and overall objectives.

Venture capital trusts

Venture capital trusts (VCTs) offer attractive tax breaks: investors receive upfront income tax relief of 30%, as long as the investment is made when the fund launches and is held for at least five years. You can invest up to £200,000 a year. This makes them attractive to people who want to reduce their income tax and can afford to tie up money for a few years.

However VCTs can be risky and the fees are usually higher than those for many other types of investments. As VCTs are restricted to investing in small unquoted companies – hence their higher risk – they can be difficult to sell, although some managers offer share buy-back

Key benefits of VCTs:

- 30% income tax relief on investments (maximum investment £200,000 gross in a tax year), subject to sufficient income tax liability during the tax year of investing and holding the investment for at least five years
- no income tax payable on dividends paid by the VCT
- no CGT payable on growth, provided the investment is held for five years or longer (no loss relief available).

A VCT could be suitable for people:

- with substantial income for the tax year during which they invest
- with substantial assets other than their home and cash
- who understand risk, are experienced and prepared to invest at higher risk
- who are able to invest funds long term.

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schemes. In many cases the manager sells the investments and winds up the scheme after six or so years, distributing the proceeds to the investors. Some VCTs pay dividends, generally 3%-5%, and as they are tax-free they are an attractive option for people looking for income.

Enterprise investment schemes

Like VCTs, Enterprise investment schemes (EISs) invest in start-up companies, but they are considered to be riskier as an EIS often invests in just one company, while VCTs generally invest in a range of companies, sometimes as many as 20 or 30. However, their various tax advantages can make them attractive to people who have recently realised capital gains, or who want to reduce the value of their estate for inheritance tax purposes.

You can invest up to £500,000 a year, on which you will receive 20% income tax relief as long as you keep the investment for three years. Any gains are free of capital gains tax and up to 40% loss relief is available should a holding fall in value. Roll-over relief is also available for other gains made less than three years before investing and up to one year after.

Many investors use EISs for inheritance tax planning, as EISs held at death receive 100% relief from inheritance tax as long as they have been held for two years.

Tax-considerations should be secondary!

Clearly there are still a number of ways high earners can reduce their income tax bill, despite the new restrictions on pension contributions. However, such investments should not be made with the sole aim of reducing income tax – but if clients have money to invest, then it makes sense to consider the tax-efficient options open to them.

Key benefits of EISs:

- 20% income tax relief (maximum investment £500,000 gross in any one tax year), subject to sufficient income tax liability during the tax year of investment and holding the investment for at least three years
- no CGT on growth if held for at least three years (loss relief available)
- CGT deferral relief for assets disposed of three years prior to, or within 12 months of, investing in an EIS
- investment exempt from inheritance tax if held for two years or longer.

An EIS could be suitable for people:

- looking to defer CGT liabilities from recent tax years
- seeking to mitigate inheritance tax
- with substantial assets other than their home and cash
- with substantial income and able to invest long-term
- who understand investment risk, are experienced and prepared to invest some assets at higher risk.

LighthouseCarrwood advisers are experienced in working with accountants to advise business owners, the self-employed and people on high incomes on tax-efficient ways of investing. This includes VCTs and EISs, areas in which we have specialist knowledge and expertise. If you feel that your clients would benefit from talking to one of our expert independent financial advisers, please contact us.

LighthouseCarrwood is one of the UK's leading providers of financial planning services to professional practices. We would be delighted to work with you to help your clients reduce their tax liabilities. To discuss how we could work with your firm in a way that suits you and benefits your clients and your business, please contact:

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