



## Using tax allowances wisely in an era of higher taxation

As the deadline for submitting online self-assessment tax returns approaches, Andy Gadd, Head of Research at Lighthouse, reminds us that there are still plenty of ways individuals may be able to reduce their tax liability and that tax savings should always be made in the context of an overall financial planning strategy.



**T**his year employees will have to work 208 days until they have paid their share of government spending, according to campaign group The Taxpayers' Alliance. The Cost of Government Day as it is known is 26 July this year, four days later than in 2007 when the figure was last

calculated. This research is similar to Tax Freedom Day, calculated by think-tank the Adam Smith Institute, which measures the number of days that taxpayers must work before they have paid their taxes, which in 2011 was 30 May.

These dates highlight the importance of ensuring that each individual makes best use of the income and capital that they have, with tax planning playing a crucial part in this. So as the deadline for submitting self-assessment tax returns approaches, here are some relatively simple – and a couple of not so simple – tax planning ideas to consider for clients:

### Maximise use of personal allowances and lower tax bands

All individuals are taxed separately and are responsible for completing their own tax returns and paying their own tax. It is important to make use of any currently unused allowances – non-working wives and mothers are the most common non-taxpayers. Switching income from a higher rate taxpayer to a spouse paying a lower tax rate can result in valuable savings. Special rules apply to income derived from assets held jointly by married couples.

Normally the income is split equally and so each spouse is taxed on half. If the beneficial interest is not 50:50 the couple can make a declaration to HMRC and pay tax on the income from the nominated asset according to each spouse's share. The declaration must represent the genuine beneficial interest in the jointly held asset – although transfers can be made between spouses without tax implications. This means, for example, that if an asset is held 70:30 the couple can either split the income 50:50 for

tax or 70:30 – whichever best utilises both the lower tax bands. The 50:50 rule does not apply to earned income or the year in which a married couple separated. (There are a number of additional exemptions to the 50:50 rule such as, the fact that it does not apply to spouses who hold shares jointly in certain close companies – dividends are always allocated according to each spouse's actual shareholdings.)

### Dividends or Interest?

Tax alone should not determine the choice of investment – it is important to remember that individual non-taxpayers cannot reclaim the tax credits on UK dividends (10% of the gross) but can reclaim the tax credit on interest payments. If this inability to reclaim tax credits on UK dividends is considered important, fixed interest or cash deposit investments might be more attractive as tax may still be reclaimed/not paid by non-taxpayers on these investments.

This differentiation in tax treatment may also be a factor when considering the investments to be held in an ISA. This is because the ISA manager is unable to claim back the 10% tax credit on UK dividend payments on behalf of individual investors but is able to reclaim the 20% tax credit deducted from interest payments such as those paid by various corporate bonds etc.

### Select tax-free investments where appropriate

Some investments provide tax-free returns, eg certain National Savings offerings and Individual Savings Accounts. Remember however that tax-free National Savings offerings are likely to be of little interest to non-taxpayers, especially if there is a price to pay in terms of restrictions on access to the funds, additional charges or a lower projected return.

ISAs are especially attractive to higher rate taxpayers who can reclaim any savings income tax deducted at source (20%) plus they will not incur a further 20% liability. Also higher rate taxpayers do not suffer the additional higher rate liability on dividend income (22.5% of the gross payment) – although, as I explained above, the 10% tax credit for UK

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dividends is not reclaimable even in an ISA. (The advantages discussed are, of course, even greater for people paying additional rate income tax.)

## Ensure that if appropriate an individual utilises their annual CGT allowance before the end of the tax year

In terms of the annual CGT-free allowance it is a case of “use it or lose it”. There are various planning strategies to achieve this such as bed and ISA or bed and pension; or you might even bed and spouse/civil partner!

## IHT Planning

With the IHT nil-rate band frozen at £325k per individual until 5 April 2015 and from then only increasing in line with CPI, the real value of this allowance may become an issue for certain individuals or couples. An exemption that should be considered if IHT is, or may, be an issue in the future is the £3k annual gift allowance. This isn't quite a case of “use it or lose it” as the allowance can be carried forward one year but it should nevertheless be considered by appropriate individuals and might even be used in conjunction with a pension payment for grandchildren.

## Consider investments that offer tax relief, either for the initial input or future profits

**ISAs:** The debate has long run about which are better, ISAs or pensions, and the simple answer is probably a combination of the two but with the ISA representing a first port of call for the majority due to the fact that there are no restrictions on access, while there are restrictions on access for pensions due to their potential added tax advantages.

**Pensions:** In terms of tax treatment, a major advantage of pensions is that they provide tax relief on the way in at a person's highest rate (with for personal contributions the excess over the basic rate of 20% being paid to the individual rather than into their pension scheme via self-assessment). In addition once the money is in a pension scheme they provide virtually tax-free growth (the tax treatment is only “virtually” tax-free because like ISAs pension schemes are unable to reclaim the 10% tax credit on UK dividends.) In addition pensions may be attractive because although very few private companies now offer final salary arrangements most employers will at least match employee pension contributions – some even put in more. In simple terms this can be seen as a pay rise – surely it would be madness to refuse?

Higher rate taxpayers should perhaps focus more on pensions. Take an extreme example. Someone with an income of £105,000 is paying an effective rate of income tax of 60% on the top £5,000 of their income due to the loss of personal allowance. Paying money into a pension gets round this.

**Venture Capital Trusts:** For those willing to take a higher risk VCTs could be an option. They are quoted companies which generally invest in a portfolio of high risk smaller companies. They offer tax relief on the initial investment and tax-free growth and dividend payments on the underlying investment, provided various conditions are met. They are known as tax reducers because they provide tax relief based on an individual's income tax liability – 30% tax relief is currently available on the initial investment (up to a maximum of £200k) to all investors up to the total level of their tax liability to fund the repayment. Once the tax liability has been reduced to zero no further tax can be reclaimed.

**Enterprise Investment Schemes:** Unlike VCTs, EISs focus on individual companies and are therefore generally higher risk than VCTs. Like VCTs they are covered by various rules and restrictions but in simple terms their major advantage over VCTs is their ability to allow CGT deferral on other investments previously held by an individual where the gain (not just the CGT liability) is invested in EIS shares.

## Don't lose sight of the overall strategy!

Never let the “tax tail wag the investment dog” when determining an investment strategy and asset selection, and certainly not when considering a person's attitude to risk and capacity for loss. Ultimately there is little point in saving tax if the investment is inappropriate. Yet with the Government looking to take more of our income and capital in tax, do not ignore tax planning either. The best course of action is undoubtedly to offer clients tax-planning advice in conjunction with a qualified, experienced IFA.

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 put in place an efficient tax-planning strategy that matches their investment profiles and objectives. To discuss how we could work with your firm in a way that suits your practice, please contact: Mark Dallas, Managing Director, on 07899 981607 or [Mark.Dallas@lighthousegroup.plc.uk](mailto:Mark.Dallas@lighthousegroup.plc.uk). [www.lighthousecarrwood.co.uk](http://www.lighthousecarrwood.co.uk)