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TAX YEAR END PLANNING 2011

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Introduction

With the UK struggling to come out of recession, the Coalition Government has established a clear programme of austerity measures and is looking to raise as much tax revenue as possible, designed to cut the budget deficit. While this raising of tax revenue has not received the same high profile exposure as the budget cuts have, it is nevertheless clear that the two go hand in hand.

In December, the Office of Tax Simplification issued an Interim Report setting out a review of tax reliefs. While the key purpose of the review was to ensure that all reliefs remain fit for purpose and take into account the level of administration and complexity, the cost of providing these reliefs and whether they remain will clearly also be a consideration.

The end of the tax year is always an ideal time for individuals to review the exemptions and reliefs available to them, and in the current environment this is more essential than ever. In the following paragraphs, we outline those areas which should be considered as part of your tax year-end review and which may be of interest. While not all exemptions, reliefs and tax-advantaged investments will be appropriate for you, most will be worth considering.



Income Tax Planning	
	Paragraph
Divert income producing investments/assets to your lower taxpaying spouse/civil partner Business owner/managers should consider dividends/pensions over salary, and diverting dividends to spouses/civil partners	1a, 1d 1b, 1c
Consider non-income producing investments for individuals & existing trusts	1e, 1f, 4f
Invest in low-yielding Unit Trusts and make use of your CGT annual exemption	1f, 2c, 4f

Capital Gains Tax (CGT) Planning	
Divert investments to lower taxpaying spouse/civil partner	2a
Maximise pension contributions to reduce CGT	2b
Invest in Investment Bonds to avoid CGT altogether	2c
Business owners should maximise Entrepreneurs Relief and pensions for diversification	2d
Use an Enterprise Investment Scheme (EIS) to free capital, defer CGT, enable diversification and reduce tax	2e
Transferring gains into a pension will neutralise the impact of CGT	2f
Create a trust fund for your children and grandchildren, and utilise each of their CGT annual exemptions	4b

Inheritance Tax (IHT) Planning	
Implement a Deed of Variation where a bequest has been received from someone who has died in the last 2 years	3b
Immediately reduce your estate by utilising the £3,000 annual exemption and normal expenditure out of income; and trust funds for children.	3a, 3g
Consider implementing a gifting strategy through trust based solutions	3c
Non-UK domiciles should transfer their assets into an Excluded Property Trust	3d
Make use of assets which provide 100% relief from IHT	3e
Ensure your Will is up to date and that full use of the transferable nil rate band is made	3f

Planning with Tax Advantaged Investments	
Make use of ISA allowances	4a
Ensure you utilise your children's CGT allowances	4b
Invest in Venture Capital Trusts (VCT) to benefit from income tax relief of up to 30%	4c
Use EIS to claim income tax relief of up to 20%	4d
Contribute to a pension to claim relief of up to 50%	4e
Companies should maximise pension contributions immediately to maximise corporation tax relief	4e



1. Income Tax Planning

What We Know

Income Tax rates for 2011/2012 will be 10%, 20%, 40% and 50%. The major points to note are:

- The Personal Income Tax Allowance has been increased by £1,000 to £7,475.
- The starting point for Higher Rate Tax (40%) reduces to £42,475, meaning that for 40% taxpayers the increase in Personal Allowance is almost entirely wiped out.
- The starting point for Additional Rate Tax (50%) is £150,000, which, unlike the other Tax Bands, is not subject to indexation.
- Individuals with income of more than £100,000 may lose some of their standard Personal Allowance and pay Tax at an effective marginal rate of 60%.

What You Should Think About

- a. If you are married or in a registered civil partnership and have taxable income incurring tax at either 40%, 50% or even an effective rate of 60% (on income between £100,000 and £112,950) significant savings can be achieved by diverting income into your lower earning partner's name.
- b. Where married couples or those in a registered civil partnership run their business through a company, it may be sensible for salary payments or dividends to be shared as evenly as possible. (This follows the taxpayer's success in the case of *Jones v. Garnett* – the so-called Arctic Systems Case. This case was in 2007 and there has been no sign that the Government intend to introduce legislation that would change this relatively uncontroversial opportunity.)
- c. If you are running your own company, you should look to draw a combination of salary, dividends and pension contributions to limit the overall rate of tax as much as possible.
- d. Where a Higher or Additional Rate taxpaying spouse or civil partner owns investments, income from these may suffer tax at a rate of up to 50%, or 42.5% if they are dividends. Subject to practical considerations, the transfer of investments to a lower or even a non-taxpaying partner will save tax and increase the overall net investment returns. Such transfers must, however, be outright and unconditional.
- e. Investments held within discretionary trusts can see effective rates of Income Tax in excess of 50%, which can have a significant impact on investment returns. An alternative investment strategy geared to either capital growth or non-income producing investments, such as investment bonds, can significantly reduce this impact.
- f. Finally, if you are a 50% taxpayer with funds to invest, with Capital Gains Tax at 28%, you may want to consider investments which generate capital growth, such as unit trusts, or wrappers that can defer tax charges, such as investment bonds.



2. Capital Gains Tax (CGT) Planning

What We Know

- For individuals, the rate of CGT remains at 18% where total taxable gains and income are less than the upper limit Income Tax Basic Rate band.
- Where gains and income are in excess of this figure the rate of CGT is 28%.
- The rate of 28% also applies to trustees and personal representatives of deceased individuals.
- The annual exemption, which is the amount of gains that an individual can make before he or she pays CGT in 2011/2012, is £10,100.
- The other CGT relief worthy of note is that available to business owners – Entrepreneur's Relief. This is set at 10% with a lifetime limit of £5m on qualifying gains.

What You Should Think About

- a. When there was one rate of CGT (for all taxpayers it was 18% from April 2008 until June 2010) it did not matter which spouse or civil partner realised a capital gain. Now it can be beneficial to ensure that the taxable gains are made by the lower taxed spouse/civil partner. Indeed, even if both spouses or civil partners are taxed at the same rate there may still be an opportunity to use two annual exemptions, rather than one.
- b. With the rate of CGT dependent on your total taxable income, it is worth taking action to reduce income potentially resulting in a lower CGT rate. Higher Rate relief on pension contributions being given by an extension of the Basic Rate band is one way of providing an indirect saving.
- c. If you are a Higher and Additional Rate taxpaying investor, particularly where you regularly use your annual exemption, you should carefully consider the type of investment wrapper that will give you the most tax-efficient return on your investment. Prior to the latest CGT changes, it was generally thought that investment bonds were preferable for income portfolios and Unit Trusts were preferable for capital growth; however, following the increase in the rate of CGT, investment bonds now look more attractive for a wider range of portfolios.
- d. The increase to £5m of the Entrepreneur's Relief band applying from 23 June 2010, will have been of interest to business owners. Those who retained profits inside the company and suffered a lower rate of Corporation Tax, in order to avoid high levels of Income Tax on remuneration from companies, would have particularly welcomed their relief increase. Subject to retained profits being put to trading use, business owners will only suffer a further CGT rate of 10% on sale or disposal of the company up to the new £5m Lifetime Allowance. Reliance on a business as the sole or main means of providing financial security is an excessively undiversified, and therefore high risk, strategy. However sound the business may be, alternative means of providing for the future such as pensions or other suitable investments should always be considered.
- e. Where you have significant gains within your equity or property portfolios you may feel trapped and unable to restructure your investments, either for investment or tax planning reasons. The simplest route would be to liquidate the portfolio and suffer CGT at up to 28%. However, it is possible to transfer up to the amount of the gain into an Enterprise Investment Scheme (EIS)*. This releases the capital and allows you to take advantage of diversification and/or make your investment more tax-efficient. It will provide income tax relief of up to 20%, significantly negating the CGT liability if and when it eventually arises, and IHT relief after two years.

**The underlying investments of an EIS are usually held in very small UK companies. As such, there is a risk that any of these investments may not perform as hoped and in some circumstances may fail completely.*
- f. By transferring some or all of the gains on your equity and property portfolios into a pension, you will effectively negate the impact of the CGT liability and, in fact, make an immediate profit of up to 22% thanks to Income Tax relief on pension contributions.



3. Inheritance Tax (IHT) Planning

What We Know

- Not only did the Coalition Government fail to make any changes to IHT in their first Budget, with the Conservative Party having previously stated that they would increase the nil rate band to £1m per person, but also they left unchanged the previous Government's freezing of the nil rate band at its current level of £325,000 until at least the end of the tax year 2014/2015.
- The most significant change to IHT legislation in recent years was the introduction of the ability to transfer any unused nil rate band on the death of the first of a couple to die, to the surviving spouse or civil partner for use against their estate on their subsequent death. These provisions mean that, at current levels, up to £650,000 of a combined estate could pass free of IHT. Amounts exceeding this value on death will broadly be taxed at 40%. Couples with estates in excess of £650,000, or individuals with estates in excess of £325,000, may still want to take some action to mitigate potential liabilities.

What You Should Think About

- a. You may wish to consider taking advantage of your £3,000 annual gift exemption. If this is not used it can only be carried forward for one year before it is lost. For more substantial gifts, you could consider creating trust funds for dependants and gifting any unused income – such gifting may ensure those amounts are immediately outside the estate for IHT purposes.
- b. If you have been the recipient of a bequest upon the death of a friend/relative within the last two years, consideration should be given to the use of a Deed of Variation.
- c. If you have capital available, you could look to utilise trust-based solutions, which can provide you with access to capital or income, while at the same time mitigating your liability to IHT. Solutions also exist whereby you have no further access to capital or income but give you full control.
- d. If you are non-UK domicile, consideration should be given to the use of Excluded Property Trusts, which allow full access to capital, while at the same time allowing you to place assets immediately outside your taxable estate.
- e. If you own business assets, including Alternative Investment Market (AIM) shares or agricultural property, there is a valuable 100% relief available. You should take advice to consider whether you satisfy the appropriate conditions.
- f. Despite the ability to transfer the nil rate band between married couples and registered civil partners, it is essential to have an efficient and up-to-date Will. If you do not currently have a Will you should ensure that one is written, and if you do have a Will you should ensure that it is regularly reviewed, such that it still fully reflects your wishes and makes maximum use of the tax opportunities available.
- g. If you wish to reduce your estate, you can consider outright gifts but should take advice as to the appropriate structures available, depending on the level of control and/or access required on any gifted sums.



4. Planning with Tax Advantaged Investments

Introduction

Managing your investments, including adopting appropriate asset allocation strategies to produce reasonable returns without high risk exposure, is an absolute priority in portfolio planning. However, maximising the tax efficiency can substantially add to the ultimate return. There are a variety of investments that are 'tax advantaged', meaning they provide some form of income and/or Capital Gains Tax benefits at one or more points during the investment term. They include:

a. **Individual Savings Accounts (ISAs)** provide a broadly tax-free return, being exempt from CGT and any personal liability to Income Tax. The maximum annual contribution is £10,200 with a maximum contribution into a Cash ISA being £5,100.

b. **Investing for children or grandchildren** may also represent a tax planning opportunity, such as:

- Setting up a pension plan for a child or grandchild and making payments of £2,880 (£3,600 after Basic Rate Income Tax relief) per annum
- Establishing a bare trust for your heir's benefit and either investing in Unit Trusts to utilise the heir's CGT annual exemption, or Offshore Investment Bonds to utilise the heir's Personal Income Tax Allowance.

c. **Venture Capital Trusts (VCT)** provide a number of tax advantages. 30% Income Tax relief is given on investments up to £200,000 per annum; dividends are Income Tax free and any gains are free from CGT.

d. **Enterprise Investment Schemes (EIS)** provide Income Tax relief of 20% on investments of up to £500,000 per annum. It is also possible to defer the payment of CGT or avoid it altogether if these are held until death, on gains made on the disposal of other assets. EIS investment gains are also exempt from CGT, provided they have been held for three years.

It should be noted that in respect of both VCTs and EISs the tax privileges granted are intended to compensate for the high investment risks that are typically associated with them.

e. **Pensions** are still tax advantaged investments, despite the introduction of the new rules. These changes will impact considerably the amount you can pay into a pension and also how much you can take out at retirement. At the same time, the new rules have abolished the need to purchase an annuity at age 75, which increases their flexibility. The main changes are from 6 April 2011, when the maximum that you can pay each year into a pension will be 100% of salary or £50,000 whichever is the lower, and the Lifetime Allowance will reduce from £1.8m to £1.5m.

The planning opportunities to consider are:

- o Given the first change takes effect from April 2011, there is an opportunity to consider maximum funding into your pension, if your total income is less than £130,000 within this tax year. If, for example, you had earned £100,000 this tax year, the maximum you would be able to contribute would be £100,000, whereas next tax year this would reduce to £50,000.
- o With a lot of businesses having a tax year end of 31 March, the directors of such businesses should again consider the maximum funding of pensions as a way of obtaining Corporation Tax relief and additionally, increasing pension provision for themselves.



- o If you have a pension fund valued close to £1.8m and are over age 55, you might want to consider the option of taking the benefits, noting that it is possible to take the available tax free cash without any income. Taking benefits will mean that the fund does not exceed £1.8m, therefore avoiding an additional tax charge of 55%.

- g. **Other tax-efficient investments** could include growth-orientated Unit Trusts and Investment Bonds. Growth-orientated Unit Trusts take advantage of lower rates of CGT compared to Higher and Additional Rates of Income Tax, while Investment Bonds can help to control whether any taxable income arises during the investment period as well as offering a number of opportunities to mitigate the ultimate liability upon final encashment.

If you would like further information on any of the areas discussed here, or generally on financial matters that may affect your plans for 2011/2012 and beyond, please contact your AAG Wealth Manager.

The Information above is based on our understanding of current taxation rules which are subject to future changes in legislation.