



Your Personal Tax Audit 2011/12

BRIEFING

The familiar tax year in the UK, 6 April to 5 April, forms the basis for both Income Tax and Capital Gains Tax (CGT) compliance – known as self assessment. The self assessment return itself has to be submitted either in paper form by the 31 October following the end of the previous tax year or, as in most cases, electronically by 31 January.

That said, however, tax years are relevant also for Inheritance Tax (IHT) and indeed for other purposes also (eg residence and domicile). This Briefing does not address issues of residence and domicile, save to note that the proposed comprehensive statutory test for residence has been deferred from 2012/13 to 2013/14.

In this Briefing we shall review what we consider to be the principal tax mitigation points to be taken on board for 2011/12.

Income Tax

The basic rate of 20% applies to taxable income up to £35,000, after deducting the standard personal allowance of £7,475. This is subject to an increase to £9,940 for those aged between 65 and 74 or to £10,090 for those aged 75 and over. Where at least one spouse or civil partner was born before 6 April 1935, there is a married/civil partner's allowance of £2,800 (though this is given only at 10%) which rises to £7,295 for couples or partners aged 75 and over. Where income exceeds £24,000, there is a reduction in all these

age-related reliefs, so that the excess over the basic personal relief is reduced by 50% of income over that limit.

Taxable income falling between £35,000 and £150,000 is taxed at the higher 40%, with a 50% additional rate applying on income over £150,000.

A nasty point arises with the personal allowance, which starts to be restricted where taxable income exceeds £100,000, with £1 of personal allowance removed for every £2 of income, so that the personal allowance is not given at all to those with income over £114,950. This means that on incomes between £100,000 and £114,950 there is an effective rate of Income Tax of up to 60%.

On top of Income Tax, there are of course National Insurance Contributions whether Class 1 for employees (both employer's and employees' contributions), Class 1A (employer's contribution on most benefits), Class 2 flat rate and Class 4 graduated on the self employed and voluntary Class 3 flat-rate contributions. That's just a brief reminder and we do not deal further with those.

So, what action can be taken now to reduce your taxable income in 2011/12, especially below one of the thresholds?



Pensions

Subject to the overall lifetime allowance of £1.8 million (set to reduce to £1.5 million from 6 April 2012), an individual can contribute the lesser of 'relevant UK earnings' for the tax year and £50,000. This is subject to the point that anyone, whether working or not, can contribute £3,600 gross into a 'stakeholder pension', that is £2,880 net, on which the pension provider will recover 20% basic rate Income Tax from the Government.

Any excess over the permitted maximum attracts what is called an 'annual allowance charge'. However, this charge does not apply to the extent that there is any unused allowance to carry forward from 2008/09, 2009/10 and 2010/11, given that the individual was then a member of a pension scheme and contributions in any of those years did not exceed the deemed then allowance of £50,000. Her Majesty's Revenue and Customs (HMRC) have just announced a (favourable) amendment to this current transitional period; if in any of those three transitional years more than £50,000 was contributed, that excess does not reduce any amount which is available for carry forward from one or other of those years.

So thought should be given to possible pension contributions, subject always to cash-flow. In particular any unused allowance from 2008/09 will be forfeited, if not used before 6 April 2012.

Furthermore, anyone with total pension funding between say £1.5 million and £1.8 million should consider electing no later than 5 April 2012 for 'fixed protection'. While an election means that no

further tax - relieved contributions may be made, the percentage excess over £1.5 million will be applied to any future up-rating of the lifetime allowance.

Regular review of pension investments and future pension policy (including drawing of the 25% tax-free lump sum in whole or in part after the age of 55 on a regular basis) is always a good idea.

Gifts to charities

A gift to a charity, which is made under a Gift Aid declaration, is taken to be net of the 20% basic rate. It is essential that the donor is liable in 2011/12 for Income Tax and/or CGT of at least that tax which is transferred by the Government to the charity, as if not they will get an Income Tax assessment to that extent and the charity will get the tax recovery anyway.

However, if the donor pays Income Tax at the higher or additional rate, the grossed up amount of the total charitable donations in effect secures further tax relief by extending the basic rate band. So, for example, total charitable gifts of £8,000 net equate to £10,000 gross. Someone with a taxable income of say £175,000 will receive a further £3,000 additional rate relief, so costing him/her just £5,000 to put charities in funds worth £10,000.

Gift Aid relief is also available to charities based in countries within the European Economic Area (the European Union plus Norway and Iceland).

Further, gifts of assets other than cash can attract Income Tax relief, in broad terms shares in listed



companies and UK land whether leasehold or freehold. The market value of the property given attracts tax relief at the marginal rate, though no benefit is secured by the charity. Again, however, a gift of listed shares of £10,000 will in effect cost an additional rate taxpayer just £5,000. Such gifts will not trigger CGT on any gain.

It is possible to elect to carry back to the previous year Gift Aid donations made in the previous year. However, the election must be made before the earlier of 31 January after the year end and the date on which the tax return for the previous year is filed. So, it may be worth reviewing whether such action might usefully be taken in relation to 2010/11.

Enterprise Investment Scheme (EIS) and Venture Capital Trust (VCT)

An investment or investments of up to £500,000 per annum in qualifying EIS companies (unquoted trading companies) attract(s) Income Tax relief at 30%. In broad terms the investor with their associates must not own more than 30% of the company. Equally, chargeable gains can be sheltered by way of deferral through an investment into an EIS company.

A VCT is rather like a unit trust of qualifying companies. Here the maximum annual investment is £200,000, again securing Income Tax relief at 30%.

The investment must be retained for at least three years (EIS) or five years (VCT).

The tax reliefs for VCTs are not quite so good as for EIS, though VCTs are on the face of it less risky in view of the spread of companies inherent in them. One advantage an EIS has over a VCT is that the shareholding may attract 100% business property relief from IHT once held for two years.

Married couples/civil partners

Following the House of Lords decision in *Jones v Garnett*, we have no so-called 'income splitting' rules (under which HMRC would have power to attribute to the working' spouse/civil partner dividend income received by the other, for tax purposes). Accordingly, Income Tax liability will generally follow the receipt of income without application of the anti-avoidance settlements legislation, subject to certain specific exceptions such as dividend waivers. So, for example, if each of husband and wife own 50 out of 100 issued shares in a company, dividend income will be assessed on the recipient, notwithstanding that one of them is the whole or the predominant wage earner within the business.

There is a presumption that income from assets which are jointly owned by the spouses or civil partners arises 50/50 for Income Tax purposes, unless a declaration is made for some other split in accordance with a declaration of trust as to the beneficial shares. This would apply to interest income on bank deposits, dividends on shares held jointly (though not within a stockbroker's nominee company) and rental income. For example, consider a higher rate taxed wife and a basic rate husband with £10,000 net rental income from property which is beneficially owned as to



80% by the wife and 20% by the husband. It would make sense not to disturb the 50/50 split in this case as a declaration would cause 30% of the income to be taxed at 40% rather than 20%!

Capital Gains Tax Planning

Chargeable gains less allowable losses for the tax year are charged to tax to the extent that they exceed the annual exemption of £10,600. The rate of CGT is either 18% or 28%. It is 18% to the extent that the net gains when added to taxable income do not exceed the higher rate threshold of £35,000 and otherwise 28%.

Losses realised in the tax year automatically reduce chargeable gains even if the effect is to 'waste' the annual exemption. By contrast, a loss carried forward from the previous year has the effect of reducing the chargeable gains for the subsequent year to the limit of the annual exemption.

Entrepreneurs' relief applies a favoured 10% rate of CGT to qualifying business interests or assets, whether the business is a company or not. Each taxpayer has a lifetime limit of £10 million of entrepreneurs' relief gains. The rules are complex and detailed advice is required on any qualifying disposal.

Transfers between spouses and civil partners, who are married and living together in all or part of the tax year, occur on a 'no gain no loss' basis. And so, subject to some anti-avoidance rules, if spouse A owns an asset standing at a gain of £20,000 and spouse B an asset standing at a loss

of £10,000, it might make sense for spouse B to give the asset to spouse A well in advance of disposal, so that the loss can be netted off against the gain. Care should be taken in these circumstances, to avoid any risk of HMRC arguing that the loss-making asset has in reality been sold by spouse B.

If an asset has become of negligible value, it may be possible to make a claim to set the loss against chargeable gains.

Where a subscription has been made in a qualifying unquoted trading company, a loss arising on the shares can be set against taxable income rather than gains, by election, submitted on or before the second 31 January falling after the tax year of the loss.

Foreign Currency Bank Accounts

Sterling cash is not a chargeable asset, whereas foreign currency is. The Government proposes from 2012/13 to exempt from CGT chargeable gains and allowable losses. It could therefore be worth considering triggering any losses before 6 April 2012 while deferring the crystallisation of any gains until after the end of 2011/12.

Main residence relief

The special and well known only or main residence relief does not operate tax year by tax year. However, any tax year audit is a good occasion to review such planning especially where one has more than one residence.



It is possible to elect within two years after a change in any combination of residences to nominate, which is the main residence for purposes of the relief. Once an election has been made it can be varied in future. Judicious making and varying of elections can in effect secure relief for two properties within the 36 months before disposal of the first.

A married couple/civil partners living together can have only one main residence qualifying for relief between them at any one time.

Tax advantaged savings

Subscriptions to Individual Savings Account (ISAs) and Child Trust Fund (now closed to new entrants) do not attract tax relief, but enable cash and/or investments to be put into a vehicle which is free from income tax and CGT until encashed. The limit for ISAs for 2011/12 is £5,350 for a cash ISA and £10,680 for a stocks and shares ISA, subject to an overall limit of £10,680 subscribed to both ISAs in tax year.

A cash ISA of up to £5,340 can be taken out for a child or grandchild aged 16 or 17.

Junior ISAs for children under age 18 without a child trust fund have been introduced from November 2011. The annual limit is £3,600 (to which the annual child trust fund subscription has been raised) whether in cash or stocks and shares. No withdrawal could be made before age 18.

Separately consider also contribution to a stakeholder pension as mentioned above, perhaps for a non-taxpaying or low income spouse/civil partner or for children or grandchildren.

Businesses

There may be yet scope for tax planning for business income assessed in tax year 2011/12. For example income might be deferred into 2012/13, for example bonuses, or expenditure perhaps accelerated into 2011/12, such as attracting capital allowances. In this connection the annual investment allowance on qualifying expenditure will be reduced from £1,000 to £25,000 for expenditure from 6 April 2012 (1 April 2012 for companies). Do beware the sometimes counterintuitive effect of the pro-rating rules where an accounting period spans that date.

Borrowings should be structured tax efficiently, for example so as to deduct loan interest against rental income.

Capital versus Income

It makes sense wherever possible to realise profit by way of capital gain attracting tax of up to 28% as against income subject to 50% Income Tax.

Trust Income

With a discretionary trust, consider distributions of income to those with lower taxable incomes. With a discretionary or accumulation trust, to avoid the trustees having to pay over to HMRC tax at the trust rate of 32.5% on dividend income and



otherwise 50% or 20% on net bank interest, consider creating what is called a revocable interest in possession to limit the liability of the trustees to 10% on dividends and otherwise 20%.

Inheritance Tax Mitigation

In Tax Year 2011/12, subject to the general principle that no one should give away more than they can afford, each individual could:

- Use the annual exemption of £3,000 and once used top it up to any balance of £3,000 unused in 2010/11; or
- Make gifts of up to £250 to any number of donees (who have not benefited from the annual exemption).

Without regard to the tax year, (though 'the sooner the better'):

- Consider gifts attracting the marriage exemption of:
 - £5,000 to a child
 - £2,500 to a grandchild
 - £1,000 to anyone else.
- Start or continue a pattern of regular gifts out of income. This entails a regular pattern (not necessarily completely consistent) which ensures that the donor has sufficient after tax income to maintain the usual standard of living. Proper record keeping is essential.

- Consider more substantial gifts as '*potentially exempt transfers*' which whatever the amount become exempt on survival for seven years. When made to a trust other than a charitable trust or a qualifying disabled trust (such gifts should not exceed £325,000 when accumulated with chargeable gifts within the previous seven years or IHT at 20% will become payable). 'Holdover' relief from CGT is available by election on gifts into trust so that the trustees 'inherit' to the donors base cost with no disposal for CGT purposes at that point.
- Generally, do review IHT planning in conjunction with Wills and arrangements for payment of IHT on ultimate death, which is a separate – and very substantial – subject. Especially where second marriages and stepchildren are concerned.

Conclusion

Tax can be saved by the straightforward use of the various allowances and reliefs on offer – and indeed by careful advance planning of how income and gains arise within the family and on distribution by trustees. We should be happy to consider with you further any of the suggestions made in this Briefing. For further information, please contact the head of the department :

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