

Year-End Income Tax Planning (Lecture P1357 – 17.13 minutes)

It's that time of year when tax return season is (theoretically) over, 5 April is on the horizon and we start to get queries from clients about things they could possibly do in order to save some tax for 2022/23.

The intention of these notes is just to throw a few simple ideas out. All of these suggestions are relatively simple to achieve, won't cost much in professional fees and shouldn't upset anyone on the 'other side'.

Use Personal Allowances

The personal allowance (PA) offers £12,570 of tax-free income and should not be allowed to go to waste. Which it will if you don't use it.

It isn't always easy to 'magic-up' a chunk of income, but small family companies could generate an income stream for those family members with income below the PA either by means of paying dividends or remuneration.

The remuneration route (salary, bonus, director fee etc) is more clunky as certain compliance hoops have to be negotiated (PAYE / RTI being the obvious one), but the upside is that a corporate deduction will be available providing that the payment is made for the purposes of the business and is reasonably commensurate with duties performed.

Care also needs to be taken so as not to trigger a Class 1 NIC charge for the employer as the NI thresholds for the earnings period will be lower than the PA.

The dividend route on the other hand is much simpler to put in place and can be made without worrying about PAYE obligations or NIC, but there is no corresponding corporation tax deduction. The recipient does, of course, need to have shares in order to provide the conduit through which to pay the dividend. But if these are in place, a dividend of £12,570 can be paid tax-free as this will utilise both the PA and the dividend allowance.

If businesses can afford to do so, a dividend could be paid so as to utilise not only the PA and dividend allowance but also the basic rate band (within which dividends are charged at the still generous rate of 8.75%). For a family member with no income, a dividend of £50,270 could be paid before 5 April at a tax cost of £3,124 (an effective rate of just north of 6%).

If there is a family trust in existence, conversations should be had with the Trustees with a view to making income distributions to beneficiaries who do not use their PAs. Minor children are the obvious weapon of choice. As long as the trust has not been settled by a still-living parent, gross distributions up to the PA can be made tax-free with a subsequent tax refund claim made to recover any tax deemed to have been deducted at source. For discretionary trusts, this generally means that payments of around £6,900 can be made to the child with the associated 45% tax credit (£5,600 or so) repaid later by HMRC.

Avoiding PA abatement

Personal allowances are restricted where total income exceeds £100,000 (meaning there is a full clawback of the PA where income from all sources exceeds £125,140). Remember here that interest and dividends are counted as income even though some of this income will be taxed at 0% by virtue of the savings or dividend allowances.

The effect of the PA abatement is that income in the £100,000 - £125,140 band suffers tax at an effective rate of 60%.

With this in mind there are various strategies to bring income down to £100,000 and avoid the PA clawback such as:

1. Shift income to a spouse or partner for example by transferring interests in assets such as shares and properties or by putting assets (bank accounts or rental properties) into joint names. For married couples, this can be achieved without worrying about CGT or IHT. For unmarried couples CGT needs to be considered as any transfers of chargeable assets will take at place at market value (although gift relief can eliminate any charge for transfers of assets such as shares in family trading companies or furnished holiday lets). Be careful here to make sure that the asset itself is transferred (not just the right to income from the asset) as the shifting of income alone could open the door to the arrangement being attacked under the 'settlements' rules.
2. Defer income until after 5 April where possible. [This may of course be 'kicking the can down the road' as this increases income for 2023/24, but we can worry about that this time next year.]
3. Exchange a bonus for additional employer pension contributions (salary sacrifice arrangements still work for pension contributions). Employer contributions are tax-free benefits thereby giving a tax and NI saving for the employee and an NI saving (and a corporate deduction) for the employer. You need to watch out for the annual allowance charge (see below).
4. Make personal pension contributions. "Net Income" for the purposes of the PA abatement rules means income after deducting of gross pension contributions. Paying enough pension contributions to bring net income down to £100,000 means that the pension contribution in this band will be effectively relieved at 60% (being 20% at source, an extra 20% by extending the basic rate band and the final 20% by virtue of the reinstated personal allowance. Pension contributions can no longer be carried back to the previous tax year so the payment must be made by 5 April to take effect for that tax year. Please remember to give your pension provider the heads-up that this is happening so that ducks are nicely in a row before 5 April. The pension provider may ask for information (for example to comply with anti-money laundering policies) which could take a day or so to be processed, so leaving this to the last minute is rarely a good idea. Care should be taken not to exceed the annual allowance (AA) as otherwise an annual allowance charge could be triggered. The AA is currently £40,000 but it is increased by any unused AA of the previous 3 tax years. This affords taxpayers the opportunity to make substantial pension contributions without a corresponding clawback charge.

5. Make charitable donations under Gift Aid. This also has the effect of reducing income when determining the PA abatement. Gift Aid donations should be made by the spouse with income chargeable at the higher marginal rates. Unlike pension contributions, Gift Aid payments can be paid after 5 April and then carried back to the previous tax year, as long as they are paid by the earlier of 31 January 2023 or the date when the self-assessment tax return is filed.

Transfer unused Personal Allowance

A member of a married couple / civil partnership who has been unable to fully utilise his/her personal allowance can transfer 10% of their personal allowance to their spouse or civil partner. Tax relief is then given to the recipient by means of a tax reducer equal to 20% of the transferred amount. The tax saving for 2022/23 is therefore £252 (which is not a lot, but it is free money).

What does help is that the election to transfer unused PA can be backdated 4 years (in this case to include 2019/20 if made before 5 April 2023). The election then stays in force until it is withdrawn (so there is no need to elect every year).

The election is only available for years in which both parties are not higher rate or additional rate taxpayers.

Avoid the child benefit clawback

Child benefit is clawed back in households where one of the carers has income exceeding £50,000. The benefit is clawed-back in full where income exceeds £60,000.

This means that for individuals with income in the £50,000 - £60,000 band, the marginal rate of tax on additional income is 40% plus 1% of the child benefit for every extra £100 of extra income. For a family with 2 children, this equates to a marginal tax rate of 59%. For a family with 3 children, this equates to a marginal tax rate of 66%.

Equalising income between the carers will help as the clawback charge is based solely on the income of the higher earning carer (not on joint income).

Again, making pension contributions so as to reduce "net income" to £50,000 will avoid the clawback charge (and obtain higher rate tax relief on the payment). For taxpayers with 3 children and income of around £60,000, £10,000 can be added to the pension fund at a net cost of less than £3,400.

Use the ISA allowance

The ISA allowance is still £20,000 and is available to each family member. Tax savings using ISAs are now essentially the preserve of investors with savings income in excess of the savings allowance (£1,000 for basic rate taxpayers and £500 for higher rate taxpayers). But for those in that position, these remain useful options.

ISAs are also useful alternative investments for individuals with excess cash whose pension pots are (or will be) affected by the lifetime allowance (currently standing at just north of £1 million).

Junior ISAs are also available with an annual investment limit of £9,000. These can be settled by parents without worrying about the parental settlement rules simply because they generate no taxable income.

One type of ISA which seems to fly under the radar is the “Lifetime ISA”. These were introduced in 2017 to help individuals between the ages of 18 and 40 to save either for their first home or towards their retirement. The beauty of “LISA” is that the government adds a 25% tax-free bonus on deposits up to £4,000 per year. No other ISA has that facility.

Everyone under 40 should be advised to take out a Lifetime ISA as it opens-up the possibility of £1,000 a year of ‘free money’. Contributions can then be made until age 50. For those individuals saving towards retirement, the Lifetime ISA can be accessed without penalty at aged 60. Withdrawals are tax-free.

Claims deadlines

Finally, do take the opportunity in March to review your claims deadlines. Many claims have a 4-year time limit pegged by reference to the end of the tax year. Claims for 2018/19 are therefore still in time. A quick check back to 2018/19 returns is never a bad idea.

Contributed by Steve Sanders