

Year-End Planning - Income Tax

(Lecture P1061 – 24.02 minutes)

Use Your Personal Allowances

The personal allowance (PA) offers £11,500 of tax free income and should not be wasted. You use it or you lose it.

Small family companies could consider salary / bonus payments to family members within the PA (with the added advantage that as long as the pay is commensurate with duties performed and made for the purposes of the business, a corporation tax deduction can be taken without creating a corresponding income tax liability).

Some care must be taken as to not trigger an NIC charge for either the company or the employee as the primary earnings threshold for NIC is lower than the PA (the earnings threshold for 2017/18 is £8,164). A payment of earnings between the lower earnings limit of £5,876 and £8,164 will therefore avoid an NIC charge while also creating an entitlement to retirement benefits (as earnings in this band will count toward the employee's contribution record).

While this sounds quite straightforward, do remember that earnings must be properly reported to HMRC. This means complying with RTI procedures for payroll purposes (which can be onerous and time consuming) and perhaps even setting up an auto-enrolment pension scheme that could be very burdensome for a business with no other employees. Out-sourcing the payroll function is always an option (providing this is cost-effective).

Some small shareholder-run businesses therefore choose alternative methods of using family PAs such as paying dividends on different classes of shares. While this does not bring with it the corporate deduction, the process is much less onerous and can be made without payroll, NIC or pension considerations. Remember that the combined effect of the personal allowance, dividend allowance and basic rate band means that a spouse with no other income can receive £45,000 of dividend income in 2017/18 at an income tax cost of just £2,137 (an effective rate of just 4.75%).

At the other end, remember that the PA is restricted where total income exceeds £100,000 so deferring income until after 5 April may be in order where the threshold would otherwise be breached. Even larger companies may be open to waiting until after 5 April to pay a bonus if you ask nicely.

Alternatively diverting income to a spouse to keep both spouses' income below the £100,000 abatement threshold should also be considered. This isn't always straightforward but can be achieved by putting bank accounts into your spouse's name, or transferring interests in assets such as shares and properties to your spouse in order that income from those assets is subsequently diverted. [Note that it is the asset that must be transferred and not just the income stream as the mere diversion of income alone could lead HMRC to argue that the arrangement is a settlement and that the income is therefore taxable in the hands of the original settlor being the donor spouse.]

Since the introduction of the finance cost restrictions for property businesses, it is even more important for rental profits to arise to the lower income spouse as basic rate tax-paying landowners will be unaffected by the restrictions. However whilst transferring a property to a spouse is relatively straightforward, transferring a mortgage with it is less so and usually requires either permission from the lender or the making of a fresh mortgage application (and as any new application will be based on the recipient spouse's income, one can't always expect the lender to offer the same terms). Transference of a property encumbered by mortgage may also bring with it a Stamp Duty Land Tax liability that is often overlooked.

Achieving the same result for unmarried couples is more difficult due to the CGT considerations. Transfers between non-spouses take place at market value so unless the asset being transferred is eligible for business gift relief (most commonly shares in unlisted trading companies or furnished holiday lets), the transfer will generate a chargeable gain. Assets subject to transfer should therefore be carefully selected with the objective of choosing assets which generate income (and therefore achieve the result of diverting that income to a lower-tax partner) but where no gains arise, either because of the value of the asset at the date of transfer or due the nature of the asset. For this reason bank accounts and gilts are popular candidates for transfer as they are not chargeable assets for CGT.

Using PAs of minor children is not always possible. Diverting income from a parent to a minor child will mean that any income above £100 will remain taxable on the parent under the parental settlement rules. However grandparents (or other relatives) are not parental settlors so any income diverted from non-parents to children can utilise PAs. In particular, if minor children are beneficiaries of a non-parental discretionary trust, the Trustees should be asked to consider income distributions to utilise PAs before the year end. As such distributions will carry a 45% tax credit, a net distribution of £6,325 will be covered by the PA. The 45% tax credit (£5,175) will subsequently be repaid. You will probably need the tax deduction certificate R185 so make sure you get one from the Trustees. Distributions need not be direct cash payments and can take the form of payments made for the benefit of the beneficiary such as meeting school fees.

Where one spouse has been unable to fully utilise his/her personal allowance, an election can be made to transfer some of the unused PA to their spouse. Only 10% of the PA can be transferred with relief given to the donee as a 20% tax reducer. The tax saving for 2017/18 is therefore £230. While this is a moderate amount, the claim to transfer the unused PA has a 4 year time limit and can therefore be backdated to 2015/16 (being the first tax year for which the relief applied). The claim will continue until it is withdrawn. The claim can only be made where neither spouse pays income tax at the higher rate.

Watch the child benefit clawback charge

Where child benefit is being claimed, care should be taken if possible to keep each parent's income below £50,000 to avoid the High Income Child Benefit Charge. This claws back child benefit at 1% of the benefit claimed for every £100 of income over £50,000. For a family with 3 children, this equates to a marginal tax rate of 65% on income between £50,000 and £60,000. Remember that 2 parents each with income of £50,000 will be able to claim full child benefit, whereas a family in which one spouse has £60,000 of income and the other spouse has none will be subject to a full clawback. This isn't necessarily fair but it is reality.

Make pension contributions

If income already exceeds £100,000, consideration could be given to making personal pension contributions by 5 April. The gross amount of such contributions are treated as reducing income when determining the PA abatement and this produces an effective rate of relief of 60% on pension contributions where income is between £100,000 and £123,000. Pension contributions can no longer be carried back to the previous tax year so the payment must be made on or before 5 April to reduce income for that tax year.

Care should be taken not to exceed the annual allowance (AA), or an annual allowance claw back charge could be triggered. The AA is currently £40,000, however it can be increased by any unused AA of the previous 3 tax years, thereby giving an opportunity to make substantial pension contributions without a corresponding claw back charge. Remember that the annual allowance is only £10,000 for those with income over £150,000 thereby narrowing the planning possibilities.

For those clients with spare cash to invest, the pertinent question is not how much could they contribute to a pension scheme but how much should they contribute. As a rule of thumb, pension contributions should ideally attract income tax relief at the highest possible rate that means making contributions such that there is still some taxable income - £1 will do - in the higher rate band. Taking taxable income below the basic rate threshold means that only basic rate relief is obtained on the pension contributions. In such case clients are normally better advised to defer contributions and spread them forward to obtain higher rate relief in later years. A "back of the envelope" approach to this is that pension contributions in 2017/18 should not exceed $\text{£}(\text{Total income} - 45,000) \times 80\%$.

Note that making charitable donations under Gift Aid also has the effect of reducing income when determining the PA abatement (and the child benefit clawback). In this case it is sensible for any such donations to be made by the spouse with income chargeable at the higher rates.

Employees could consider giving up salary and/or bonuses in return for employer pension contributions (salary sacrifice arrangements still work for a limited number of benefits including 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. Again the impact of annual allowance must be borne in mind.

Use your dividend allowance

This is £5,000 for 2017/18 but is reducing to £2,000 from 6 April 2018, so take advantage of the higher allowance while you still have time.

However do remember that although dividends will be taxed at zero percent within the £5,000 dividend allowance, they still count as income for the purpose of the child benefit charge and for abatement of personal allowances, so taking dividend income can sometimes inadvertently create a charge where one is not anticipated.

Similar comments can be made in respect of the Personal Savings Allowance (£1,000 for basic rate taxpayers, £500 for higher rate taxpayers) that should also be used if possible. This can be engineered by small family companies as director loan accounts can pay interest at a commercial rate to generate income within the allowance. In most cases the interest paid should be corporation tax deductible.

However income tax should be withheld at source by the company under the CT61 system so many practitioners may think that the compliance burden outweighs the (relatively moderate) tax benefits.

Family companies perhaps have more scope to take advantage of the interest rules in cases where a director has little or no income (for example director's fees or salary within the personal allowance). In addition to the Personal Savings Allowance, taxpayers have a 0% starting rate band for savings income (ie, interest) which applies where taxable non-savings income is less than £5,000. Therefore a director with a salary of £11,500 could then receive a further £6,000 in interest without any liability to income tax. Popping a further £5,000 in dividends on top means that £22,500 can potentially be paid before the year end without an income tax charge. If the interest is derived from a director's account credit then companies should ensure that the interest is actually paid to the director before 5 April (accruing for the payment is not sufficient). Again any payments would need to be made via the CT61 system with the tax withheld subsequently reclaimed.

No Personal Savings Allowance is available for additional rate taxpayers so any deposit accounts, gilts or other interest bearing products should, wherever feasible, be held by the spouse not paying tax at this rate. An inter-spouse transfer before 31 March in respect of a product paying interest on 31 March would therefore be effective.

Use your annual ISA allowance

This is £20,000 in 2017/18. This is perhaps less important than it used to be with low interest rates and the Personal Savings Allowance, but for investors with savings income in excess of the PSA, these remain useful vehicles. Again the ISA allowance is available for each family member.

One point to bear in mind here is that Lifetime ISAs were introduced in April 2017 to help investors save either for a first home or towards retirement. The government will add a 25% cash bonus on deposits up to £4,000 per year. This is "free money" of potentially £1,000 per annum and can be accessed even if you already have a home.

However only individuals aged between 18 and 40 can open a Lifetime ISA (the entry door closes on one's 40th birthday). Therefore anyone under 40 should be advised to take out a Lifetime ISA (even with a minimum deposit) as contributions can then be made a later date in order to attract the government bonus. For retirement savers, any funds in a Lifetime ISA can be withdrawn without penalty at aged 60. Unlike pensions, any withdrawals are tax-free. Practitioners should consider mentioning this to their under-40 clients.

Reduce tax liabilities by using EIS or VCT schemes

Schemes such as EIS remain very useful in reducing income tax liabilities and deferring gains. With a 30% tax reducer on offer, an EIS investment that eventually returns more than 70p in the pound (after at least 3 years) will be a profitable one.

Gains on EIS shares are exempt after 3 years. Even in the event that the investment is loss-making, income tax relief is available for the capital loss on an eventual disposal thereby further mitigating any liability.

EIS investments also permit the deferral of capital gains on any asset until such time as the EIS shares are disposed of. Retaining the investment until death is particularly attractive (if death can ever be described as such) as the deferred gain is washed-out without charge and any value left in the shares after 2 years will almost inevitably qualify for 100% business property relief.

The Seed EIS offers an even larger carrot in the form of a 50% tax reducer on investments up to £100,000 in smaller early-stage companies. A further CGT relief is given when gains are reinvested into SEIS shares with 50% of those gains qualifying for full CGT exemption (capped at £50,000). Once again gains are exempt after 3 years and losses are eligible to be offset against income.

VCT's also offer a way of reducing the income tax liability by 30% of the investment and the collective-investment nature of VCTs tend to make them (in theory) more predictable. In addition dividends are tax-free (and unaffected by the dividend allowance) and any capital gains are also exempt from CGT.

However one of the drawbacks of VCTs can be the difficulty in selling them since, although they are a listed stock market investment, no income tax relief is available for the buyer of a second-hand VCT therefore the price is driven down.

EIS and SEIS investments can be deferred until after 5 April as the subscription can be carried back and treated as made in the previous year. There is no such carry back facility with VCTs.

Contributed by Steve Sanders