

*Waveney McKenna Limited
69 Park Road
Peterborough
PE1 2TN*

t:- 01733 425818
f:- 01733 425804

Taxation and Planning Concerns

For Higher Earners

3rd August 2009



Prepared by:-

*Ian Burrows APFS CFP
Chartered Financial Planner*

CONTENTS

1. Introduction
2. Objectives and Priorities
3. Background
4. Tax planning for High Earners
5. Self Invested Personal Pensions

Appendix

1. Risk Warnings

1. INTRODUCTION

Waveney McKenna Limited is a part of the Waveney Group of Companies providing Commercial Insurance Solutions to new and long standing clients. Waveney McKenna provides a comprehensive service with a clearly defined approach to Financial Planning.

The Group was formed in 1964 and has grown to now employ over 70 staff throughout 4 offices covering the East Anglia region. Our client base extends throughout the UK and our experienced team aims to forge long term client relationships.

At Waveney McKenna we are committed to the provision of Financial Planning using a defined strategy and investment process offered by extremely well qualified and experienced advisers.

Our Advisers

Ian has over 10 years experience as an adviser and is an Associate of the Personal Finance Society, a Chartered Financial Planner and Certified Financial Planner. Maureen McKenna holds the Advanced Financial Planning Certificate with over 25 years industry experience.

Elizabeth Burrows has over 10 years industry experience and holds the Advanced Financial Planning Certificate and Mortgage Advice Qualification. Elizabeth looks after a portfolio of clients including many companies.

Our combined experience allows specialist advice to be offered in Taxation and Trusts, Investment Planning, Business Financial Issues, Pensions, Retirement options and Investments as well as Estate Planning opportunities. Specialist Advanced Financial Planning Qualifications are held in each of these areas.

2. OBJECTIVES AND PRIORITIES

The purpose of this report is to meet the following objectives:-

- Provide a summary of the current position with regard to tax changes and the impact on high earners
- Look at some of the potential areas which could be affected in future – these areas represent our own opinion and may never occur
- Alternative savings vehicles which may be appropriate
- A summary of Self Invested Pension options indicating which types of SIPPs are available in the market

3. BACKGROUND

The economic environment is poor with the Government having to bail out excesses in lending by banks together with rash borrowing by some individuals. Many individuals have borrowed significant sums of money during the good times and now face financial difficulties which bankruptcy cannot always cure.

It is widely believed that a significant number of people have high levels of personal and mortgage debt which is becoming increasingly difficult to service. Should the Government borrowing binge, designed to create liquidity and stave off systemic collapse of the banking system (and it is difficult to find another solution than printing money given that interest rate cuts didn't work) cause inflationary pressures due to excess money supply then we can expect to see interest rates increase. This will be a fine balancing act between the needs of home owners and the economy.

At this point, those who can support their interest payments on the basis of low mortgage rates could really be in trouble and further declines in house prices could occur as more redundancies from companies and local authorities who can no longer keep their head above water are likely as they face higher financing costs if they are lucky enough to be able to obtain finance in the first place.

This is admittedly the gloomier scenario, the alternative being that the additional liquidity provided by the Bank of England and monetary policy will boost the economy, overseas lenders will maintain confidence in UK Plc (and the ability to repay our National Debt), banks will lend, customers will re-enter the high street in droves (having learnt the error of excess) and UK Plc will be cured. The National Debt will still be there but higher tax revenues should cure that over the next decade or so.

Whichever scenario you believe the National Debt is a problem and traditionally when Governments run short of cash they either borrow or raise taxes, our Government is doing both and at the moment this affects high earners in particular but also those earning modest incomes.

I have summarised some of the key changes below:-

1) Changes to National Insurance Limits

These changes are now mostly old news but are worthwhile revisiting.

Whilst the Government reduced the basic rate of tax to 20% the upper earnings limit was increased. This meant that the Government income tax take reduced by a few percent but the level of income on which the higher rate of National Insurance is paid increased. All figures will use 2009/2010 income tax and National Insurance rates unless otherwise stated.

The LEL (lower earnings limit) is currently £95 per week with the Primary Threshold being £110 per week. No NI is paid if you earn less than the Primary Threshold although class 1 NI contributions are deemed to have been paid on earnings between the LEL and the Primary Threshold to provide some protection for those on low incomes.

The Upper Earnings Limit is more interesting, this has been increased significantly over the past two years thereby increasing the level of income on which National Insurance contributions by the employee are deducted at 11%. As most of us are aware 1% National Insurance is paid on all income above the Upper Earnings Limit and it is this area which could well increase further. According to the Government this is not a form of income tax.

2) Cap on Large Pension Funds

Pensions simplification did impose caps on those with large pension funds, this lifetime allowance is now £1.75 million and will increase to £1.8 million from 2010 and remain frozen until AT LEAST the 2015/2016 tax year. This allowance effectively caps income to £87,500 for those in defined benefit schemes, those in money purchase schemes have income capped by reference to the lifetime allowance and current annuity rates.

By freezing the lifetime allowance the Government is effectively restricting tax relief on pension payments, as any pension fund over the lifetime allowance is then taxed at 55% if taken as a lump sum at retirement.

3) Removal of the Personal Allowance

The personal allowance is being reduced for those earning over £100,000 per annum. For every £2 of income over £100,000 your personal allowance is reduced by £1 so if you earn £112,950 your personal allowance would be nil based on the current nil rate band.

This amendment has caused barely a ripple of protest; however, it is a significant event from a political perspective and does to my mind set a precedent. The personal allowance, much like child benefit or the state pension, has always been viewed as a right in that everyone should have the right to some income on which no tax is paid. This, previously inalienable right, has now been removed and such an action could easily be mirrored in the reduction of other "rights" such as child allowance for those earning over £100,000 or the state pension.

An individual can make a pension payment to effectively reduce their taxable income which is worth considering for those caught under this tax change.

4) Removal of Higher Rate Tax Relief on Pension Payments from April 2011

The last Finance Bill 2009 introduced the reduction to the basic rate of tax of tax relief on pension payments for those earning over £150,000. To prevent effective tax planning prior to the change certain measures have been taken, namely:-

Special Annual Allowance – can continue, or start to pay up to £20,000 and receive higher rate relief for 2009/2010 and 2010/2011. Those not using this allowance presently can do so by commencing regular payments.

Those making less regular contributions, the self employed for example, can pay the lower of £30,000 or the average of their last three years pension contributions. The figure which can be used is either the £20,000 or the lower of £30,000 and the averaged contributions over the past three years.

Defined benefit (final salary) schemes are valued at a multiple of 10 times the increase in the benefits accrued over the tax year.

Protected Pension Input Amount – contributions being paid prior to the 22nd April 2009 can be protected in full, for example even where this is £10,000 per month, so long as the payments were regular in nature and commenced before this date. Similarly, accruals in an employer's defined benefit scheme are also included.

Where a high earner joins an employers scheme with more than 20 members, even after the 22nd April 2009 then these accruals can be included in the protected pension input amount and would not incur the restricted tax relief.

Higher rate relief begins to be restricted once taxable income exceeds £150,000 (and pension payments are added back onto income to calculate total income so salary sacrifice will not work), the definition of relevant income includes the following:-

- Employment income;
- Income from self employment or partnerships;
- Pension income (from the state, personal or occupational pension schemes);
- Savings interest;
- Dividends;
- Chargeable gains from life assurance contracts or bonds (without top slicing relief);
- Rental income; and
- Income from trusts.

Any income sacrificed to make pension payments is added back onto income.

Special Annual Allowance Tax Charge

Where an individual does contribute over allowable limits (and the rules are complicated) then a tax charge on the value of the payments in excess of those allowable will be incurred at 20% for 2009/2010 increasing to 30% in 2010/2011.

5) Tax Rate of 50%

Finally a new tax rate of 50% is being introduced for those earning over £150,000 from 2010/2011.

Summary

The Government borrowing has and continues to be significant and will have to be repaid. To achieve this it is reasonable to expect either the present or indeed future Governments to increase taxation. Recent tax changes seem to be introducing the concept that certain areas which were regarded as available to all will be restricted to those on higher incomes.

For those on more modest incomes there is cause for concern. The pensions system has been revamped so often that additional changes (for the worse) will create more antipathy towards long term savings and less trust in the system. The raising of the minimum retirement age to 55, renaming of the tax free lump sum to pension commencement lump sum, potential tax charge of 82% post age 75, the 10% tax credit on dividend fiasco all combine to create uncertainty.

For higher rate taxpayers who will only receive basic rate tax relief on pension payments and who will pay higher rate tax on pension income additional pension funding will no longer be tax efficient – especially when the loss of control over capital is taken into account.

There may be an argument to continue pension funding for high earners who will only pay basic rate tax on retirement income but this option needs to be carefully considered against the loss of access to capital which results from pension payments.

4. Tax Planning for High Earners

Many tax efficient savings vehicles have become obsolete either by the failure to increase the savings limits or by the removal of tax breaks. Some still exist but care needs to be taken with the more esoteric and high risk options.

The following is designed as a brief guide only and should not be taken as advice, no advice as to the suitability or otherwise of any particular option can be provided or is intended.

ISAs – Individual Savings Accounts

At last some good news – the limit for ISAs is being increased to £10,200 from next year for all. Somewhat bizarrely the limit is being increased this year for those over 50 but only from October.

To remind you, ISAs offer the following:-

- Significant flexibility with access to thousands of investment funds
- Tax free growth
- Tax free income where fixed interest securities are held – the 10% tax credit on dividends can no longer be reclaimed

ISAs can be particularly useful when used to provide a regular income – which is not taxable. The savings limits are sufficient to remain a useful planning tool. You can invest up to half of the allowance into cash and the remainder into stocks and shares or the entire amount into stocks and shares.

The problem with ISAs for those over a certain age is that whilst the income is efficient, the capital can be taken into account in means testing for local authority care purposes. The capital also forms part of the estate for inheritance tax purposes.

MIPs - Maximum Investment Plans

Long out of favour as these are endowments by another name, however, for high earners they should no longer be ignored – especially as the industry learnt a valuable lesson and largely revamped the pricing to make them more attractive and more flexible.

MIPs offer access to a wide range of investment options and often have a low pricing structure (thanks to getting rid of hefty upfront commissions and exit charges – but be careful as some still remain). No tax relief is available on contributions which are invested in a chosen fund or range of investment funds.

Once invested the fund pays tax at the basic rate and provided the MIP is qualifying then on maturity the fund is paid with no liability to higher rate tax. To remain qualifying the premiums must be regular with the term of the plan being a minimum of 10 years. On withdrawal or maturity the plan must have run $\frac{3}{4}$ of the original term or 10 years if less.

The plan must also have life cover which typically is 75% of the premiums paid throughout the plan term, for a £100 per month MIP over 10 years then life cover would be c.£9,000.

Although out of favour for many years these plans are worth considering for High Earners the following reasons:-

- Lower charging structure on modern plans with increased investment flexibility
- No additional tax on the maturing plan proceeds – only basic rate tax will have been paid

These are not generally suited to basic rate tax payers or those who have not used other tax efficient savings vehicles.

Friendly Society Savings Plans

These allow an individual to save up to £25 per month, or £270 per annum, into an endowment style contract. Once invested the fund grows free of tax provided the endowment has a term of 10 years as a minimum.

Many providers of these types of arrangement offer plans with significant up front charges as the commission can be up to £250 so at least 1 year's payments are lost in charges. In addition, the relatively small allowable payment does make the use of these questionable, it is important to ensure that charges are kept to a minimum.

Capital Gains Tax Allowance

The new rate of CGT is 18% and given the overspend by the UK Government this is one area I would expect to see increase, however, the overall tax take on Capital Gains is relatively modest.

In any event, 18% tax to a higher rate taxpayer is attractive and the annual exemption of £10,100 per individual is significant. In effect you can make significant gains with no tax liability provided the gains fall within your annual exemption, thereafter the 18% tax rate applies.

When looking to utilise this allowance, ideally look for a risk rated portfolio suited to your investment timescale, ideally a portfolio with a low or nil yield would suit as any income will be subject to income tax. You can then encash units to utilise your CGT allowance in the future to capitalise on any growth.

Offshore Investment Bonds

These tax wrappers allow tax to be deferred indefinitely. A lump sum investment, often in excess of £100,000, is made into an offshore bond investment wrapper in jurisdictions such as the Isle of Man, Dublin, Luxembourg or Guernsey to name a few.

There are no tax breaks for investing but the fund does grow free of UK taxes (excepting a potential small withholding tax). The investment is often divided into a number of smaller investment plans allowing significant investment and tax planning flexibility.

All gains are subject to income tax by adding a slice of the gain onto income and taxing the gain according to the tax rate applicable to the individual involved. The plan holder can assign policies to other individuals which can facilitate using the available income tax allowances of a spouse or children, where over 18.

Individual segments can be assigned into trust for use in estate planning, or down a generation to other family members.

In terms of investment flexibility you are able to select from perhaps up to 20,000 available collective investments and often enjoy an open architecture structure. Individual shares cannot be held.

The charges of such investments tend to be higher than onshore alternatives and are lower for larger investment amounts; advice should be sought before proceeding with any investment.

Enterprise Investment Schemes

You can invest up to £500,000 into an EIS and benefit from 20% income tax relief. Dividends are taxable.

In addition to the income tax relief you can also defer capital gains by reinvesting into an EIS. This deferral of tax is for the lifetime of the investment and unlike the income tax relief, is unlimited. Any capital gains are tax free. Another advantage is the 100% business property relief making the shares exempt from inheritance tax once they have been held for two years or more.

It is worthwhile noting that EIS investment is designed to enable small high risk companies to obtain additional funding. These are generally high risk investments where the full value of your investment can be lost if the company ceases trading.

Qualifying companies must have gross assets lower than £7 million and carry on a qualifying trade.

Some specialist firms reduce EIS risk by using insurance based solutions; these tend to be expensive but can reduce volatility whilst allowing the participant to benefit from the tax breaks available. In any event these are high risk and generally not suitable for all. Risk can be reduced by holding a range of EIS investments.

Venture Capital Trusts

The maximum allowable investment into a VCT is £200,000 with 30% income tax relief available. Income and growth are free from tax.

Again this is a high risk investment with the maximum size of a company into which the VCT can invest being £7 million. A number of providers now structure the underlying investment to try and reduce risk, however, my concern is that should HMRC see these structures and being opaque and against the principle of raising finance for small high risk companies that some VCT's could face problems.

A significant problem with both VCTs and EIS holdings lies in the lack of a secondary market. Only new share issues qualify for the reliefs and therefore the secondary market is not inundated with investors wishing to take a high investment risk with no tax breaks, often investors find themselves locked into an account and therefore it is important to look closely at the structure and ideally aim for an investment looking to distribute high levels of return by way of dividends.

To qualify for the 30% income tax relief a VCT must be held for at least 5 years. It is important to remember that these are high risk, you can lose the entire investment and tax reliefs can be removed if the underlying companies fail to qualify or the investment manager fails to invest the funds within a reasonable time period. They are sophisticated investments and whilst tax breaks are attractive no investment should be made on the basis of tax breaks alone.

Summary

Perhaps the starting point for tax efficient investments is to use ISAs first as these offer significant flexibility combined with reasonable tax breaks in terms of tax efficient income and growth. Once these are used in full capital gains tax allowances should be utilised and MIPs considered. Offshore bonds can also play a significant part in financial planning but are generally only suited to larger lump sum investment amounts.

For the less risk adverse EIS and VCT options should also be reviewed.

5. SIPPs – Self Invested Personal Pensions

It is worthwhile referring to the tax changes to pension contributions for higher earners mentioned earlier in the report which will affect the advisability of continuing pension contributions into the future.

SIPPs are widely publicised in the current marketplace, often seen as offering a lifetime solution for an individual's needs. This can be the case but the flexibility should be considered against charges and whether an individual will actually utilise the additional options available.

Generally there are a range of SIPPs from those which bear the name but do not offer true independence and flexibility to those where the individual is a trustee of their own pension and appoints administrators who charge a fee to ensure that the individual does not fall foul of legislation and face penalties.

In general, as well as the normal tax breaks offered by pensions, SIPPs are designed to offer the following:-

- Greater control over where the assets are invested
- Tax planning, especially for business owners who would wish to purchase commercial property
- Access to a much wider range of investments
- Greater ability to use flexible trusts, for example spousal bypass or discretionary settlements for tax efficiency and estate planning

There are many SIPP providers in the marketplace offering a range of different investment options, for restricted flexibility the charges are often lower than for a full blown SIPP.

Restricted SIPPs

These are often designed to provide a wide range of investments which are easily tradable, often online. The fees tend to be lower, in some cases c.£120 to establish and £160 per year to run with trades coming in at £12.50 to £20. Investment management and Adviser fees are in addition and for the latter must be agreed between the adviser and investor.

Often commercial property is not available unless you upgrade to a full SIPP.

Many pension providers offer access to this type of arrangement and some do it extremely well. Others muddy the water by having tiered charging structures which are dependent on whether you access their own funds, a select range of funds or have total investment freedom.

Full SIPPs

These completely separate the administration of the pension from the investment of assets. The administration provider should have no interest in where you invest other than to ensure it is allowable, often specialist SIPP providers will consider investments which traditional pension companies would shy away from.

Generally the administration charges are higher, up to £600 per annum but can range from £400 per annum making this worthwhile for larger funds. The principle advantage lies in the additional options and flexibility of the administrator, however, for many investors these options are not in practice used.

Trusts

You are able to nominate a beneficiary to receive the fund from a pension in the event of death. Often a spouse is nominated and this can simply increase their estate on which inheritance tax will at some stage become payable.

A potential solution is to nominate a stand alone trust as the beneficiary for death benefits, whether from a pension scheme or death in service plan. By having the funds paid into trust they effectively bypass the spouses estate whilst leaving the spouse as a potential beneficiary with access to funds via loans should the capital be needed. These loans can then be repaid on death to the trust fund.

In this way the capital does not form a part of the surviving spouse's estate and the potential inheritance tax savings can be considerable.

Discretionary trusts do have their own nil rate band for inheritance tax purposes, if the value of assets moved into the trust on death is likely to be significant then a series of non related trusts can be established to help reduce the potential for the exit and periodic charges payable under discretionary trusts.

Your key features are enclosed; in particular please note the following:-

Investment Products

- Please note that past performance is not a guide to future returns and the value of your investment can rise as well as fall.
- You will be issued with a cancellation notice offering a fixed period of time for you to change your mind about this investment, if you exercise this right to cancel then the amount you receive may be less if markets have fallen in value. For PEPs and ISAs any tax advantages are lost on encashment or cancellation.
- The investment is designed for the longer term, typically 5 years and over.
- This advice is based on our understanding of current legislation which is subject to change.
- Where a fund invests in property and land. This can be difficult to sell - so you may not be able to sell/cash in this investment when you want to. There may have to be a delay in acting on your instructions to sell your investment. The value of property is generally a matter of a valuer's opinion rather than fact.
- Following the encashment of a with profits holding you will be forgoing all rights to future bonuses.
- For investment in Global economies this adds an element of currency risk which can increase investment volatility.
- Access to funds at short notice during periods of adverse economic performance may be inadvisable.
- Taxation levels, bases and relief's may change
- If money is being transferred then there may be a period of time when money is not invested and therefore not exposed to market movements
- Any income is not fixed and can rise and fall. If investment performance is less than the amount of income payable then capital can be used (in some arrangements) to subsidise the income taken.