

PLANNING FOR HIGHER TAX BILLS

Francesca Lagerberg considers the trade-off needed to help clients facing the new higher rates of tax

Is it a bird? Is it a plane? No, it's the new 'super-tax' winging our way for the 2010/11 tax year. Those with income over £150,000 will already be bracing themselves for the forthcoming pain of a top rate of tax of 50% knowing that if they do nothing they will have increased tax liabilities in the very near future. And of course it's not just that part of the population which will see tax hikes from April. Any individual earning a six-figure income will see their personal allowance begin to taper away with effect from 6 April 2010.

The basic personal allowance will be reduced by up to 100%, at the rate of £1 for every £2 of income above £100,000. Based on the current personal allowance of £6,475, this would mean the full allowance would be extinguished at an income level of £112,950. Where income falls within the narrow banding of £100,000 to £112,950, the gradual tapering of the allowance means that the effective rate of income tax is up to 60%. If this is earned income, National Insurance of 1%, rising to 1.5% from April 2011, will also be charged.

Also from 6 April 2010, the top rate of tax on dividend income will rise to 42.5% and the trust tax rate will rise to 50% with a new dividend trust rate of 42.5%.

These are significant tax increases – the highest in many years. Already the papers are reporting well known public figures who have the ability to move around the globe opting to relocate overseas, such as artist Tracy Emin. One wonders if she'll take her famous unmade bed with her and if so how they'll manage to pack it!

To add to the gloom for higher net worth individuals we are seeing the withdrawal of higher rate pension relief for those with income over £150,000 from April 2011 and there are already anti-forestalling measures enacted, affecting how people can pension plan.

The Budget 2009 Red Book suggests that these measures will be raising an additional £7bn in 2012/13. But will they? History suggests that large tax increases rarely bring in the expected revenue. This is primarily because people change their behaviour and the steeper

the increase the more they are likely to act. There are plenty of government-approved options that can help people effectively manage their tax rates, such as using share schemes or just the simple use of spouse exemptions. This year's *TAXline Tax Planning* book contains numerous examples of this type.

But high tax rates also breed riskier ideas that seem more attractive to those facing significant tax increases. We are already hearing strong noises from Government and HM Revenue & Customs (HMRC) about anti-avoidance rules being considered to stop aggressive tax planning in this area. These rules look set to appear in the 2009 Pre-Budget Report. Stephen Timms, the Financial Secretary to the Treasury, speaking in September, laid down a marker in this area. Although primarily talking about offshore tax havens and corporate planning, he played the morality card, calling those who avoid tax 'cheats' and stating: 'It is right for those who pay their fair share to resent – to see, in fact, as morally wrong – the actions of a small minority, who use their resources to create a new set of rules for themselves.' (see www.hm-treasury.gov.uk/speech_fst_210909.htm). Whatever your view on this type of emotive language, it is clear where the rules are heading.

I suspect many of us have little time for the wilder type of tax planning that only clings perilously to the legislation by a finger nail. Most tax advisers want long term relationships with their clients. They want to make sure those clients are aware of all the available options but equally fully informed of any risks associated with planning. They do not want to put clients unwittingly into years of bruising enquiries with HMRC or into plans that technically skate on thin ice. However, we also all want to help our clients minimise their tax liabilities. So where does the solution lie?

The answer rests with what tax advisers tend to do best. They look at the issues and consider the pragmatic way forward. They operate in the law. They think laterally and don't let tax alone dictate the final outcome. They are commercial and provide the taxpayer with sensible options and well founded

recommendations that are evidenced, and – using the new penalty regime terminology – they make sure they take 'reasonable care'. So let's park some of the assertions that everyone will be working tax alchemy and turning their income into capital to pay just 18% (or less) tax rather than 50%. Most tax planning in this area will be on far more well-trodden ground.

Below are some of the items being talked about to reduce increased tax bills, coupled with comments on where HMRC is challenging more aggressive variations.

Share schemes and incentives

Just some options to think about include HMRC-approved ideas such as Enterprise Management Incentives (EMI) and Company Share Option Plans. These are selective so can be used to target the high flyers. EMI has recently passed the European Community approval hurdle and will be around until at least 2015.

By way of contrast, Share Incentive Plans and Savings-Related Share Option Schemes must be offered on a similar basis to all employees and can therefore be more inflexible but tick the box for low-level, across-the-board incentives.

Extracting profits from a business

If the client does not want to keep large cash balances in the company given the current economic climate, then rather than considering the conventional options of bonuses, dividends or contributions to an approved pension scheme, perhaps an Employer Financed Retirement Benefits Scheme (EFRBS) is the answer.

This is an unapproved pension arrangement and therefore it doesn't have the same tax treatment as an approved pension. Contributions into the pension pot are not taxable or subject to National Insurance on the employee, although corporation tax relief is not generally available on contributions and there may be inheritance tax implications as a result.

The fund itself does not enjoy the same tax privileges as an approved scheme, but there will be flexibility over how the fund is invested. An EFRBS also provides a pension pot which is currently only taxable at 40% on death or when benefits are taken. This compares favourably to the combined 82% tax rate which can apply to the fund on death with some approved pension schemes.

Note that HMRC has issued warnings about some more aggressive EFRBS planning and this can be viewed in its 'Spotlight' number 6 (see the HMRC website pages www.hmrc.gov.uk/avoidance/spotlights.htm).

Paying in advance

You could just pay bonuses or dividends prior to 6 April 2010 to get the lower tax rates. This has obvious cash flow implications and, where relevant, PAYE and NICs would be due. Variations on this are paying several years' worth of pay and bonus this tax year to employees who would then loan back the money to their employers in return for a pre-arranged rate of interest over that period. Would HMRC view this as aggressive? Again I suspect this comes down to making sure the formalities are correctly followed.

Income shifting

Where a married couple or civil partners are in business together, clearly it may be possible for partnership profits or dividends to be shared, with both parties' income kept below the £150,000 threshold. The Arctic Systems Ltd case (*Jones v Garnett* [2007] 4 All ER 857) highlighted the pros and cons of the settlements legislation (s 660A, Income and Corporation Taxes Act 1988 as was – now s 619 et seq, Income Tax (Trading and Other Income) Act 2005) but providing the parameters of the case are adhered to most married couples should be able to structure effectively.

The proposed income shifting rules which were floated after that case have been put on the shelf – at least for the moment. The proposals at the time were proved to be unworkable. However, the wounds around this area are still raw and it would be no surprise to see some arguments for the need for change being mooted once again.

Do watch out also for aggressive dividend waivers in favour of lower rate taxpayers that could be attacked and nullified by HMRC (see the recent Special Commissioner's decision in *Buck v HMRC* SpC 716).

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