Year End Tax Alert 2005/06

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Introduction

The end of a tax year is always a good time to look at tax saving ideas, but this year brings added urgency. Major changes are taking place in the pensions tax regime from A-Day – 6 April 2006. Some opportunities will close but others will open. And don't leave your plans to the last moment – it may be too late. Sometimes the law changes on Budget Day itself, which is usually in March, so you might be safer acting before then.

Inheritance tax planning too has become more important than ever. Complicated schemes may be risky but there are many straightforward steps you can take. You should also look for ways of reducing income tax and capital gains tax, especially at the higher tax rates.

It is always a good idea to try and look at your tax planning in the overall context of your general investment, insurance and financial planning and what you are trying to achieve.

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Pension Planning

It is all change for pensions from 6 April 2006 – A-Day. A single set of rules will replace all the current different tax structures, and most pension planning will change. If you have a pension plan, you should look now at what steps you should take before A-Day and what you should delay until afterwards.

Investing in a pension plan is basically worthwhile because of the tax privileges that pensions enjoy. You get tax relief on the contribution at 22% unless you are a higher rate taxpayer, in which case it is worth 40%, and the funds are broadly free of UK tax on their capital gains and investment income. When you take the benefits, up to a quarter of the fund will normally be tax-free and the lifetime income will be taxable.

The maximum amount you will be able to build up in a tax-favoured pension scheme will be £1.5 million in 2006/07, rising in stages to £1.8 million in 2010/11. You will be penalised if you exceed this lifetime allowance with an effective tax charge of almost certainly 55%.

- If your pension fund is valued at over the lifetime allowance, or is likely to exceed it, you must take specialist advice as a matter of urgency. There are special transitional reliefs that can allow you to escape the penalties; but in many cases, they mean that you should stop accruing any further benefits and there should be no more contributions from A-Day. You should also consider whether it is worth making any contributions before A-Day, while you still can.

- If you do not have a potentially excess pension, the urgency to make contributions before 6 April 2006 is probably less and will depend on your tax position this year. Next year, the scope for making very much higher contributions will be generally much greater.

- The investment rules for pension schemes will change, but you will not be able to invest in residential property, fine wines and certain other assets, as was originally intended. However, if you want to sell an asset you already own to your pension scheme or buy an asset from it, you should wait until after 5 April.

- The rules for borrowing by pension schemes will be more restricted under the new regime. So you should set up any loans to buy commercial property as soon as possible.

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Personal pensions up to A-Day

After 5 April, you will no longer be able to relate back pension contributions to the previous tax year. So if you want to make a pension contribution to save income tax for 2005/06, you must act before the end of the tax year. Almost anyone under the age of 75 can make a personal pension contribution of £3,600 gross, even if they have no earnings.

■ You could set up a personal pension for your partner or children so that they can benefit from tax relief at 22%, even if they do not actually pay tax.

■ You can contribute more than £3,600 if you have enough earnings. You can pay 17.5% to 40% of net relevant earnings to a personal pension scheme, depending on your age.

Additional voluntary contributions

If you are a member of an employer's pension scheme, you can top up your ordinary annual contributions – subject to a limit of 15% of your earnings – by making additional voluntary contributions (AVCs). To obtain tax relief for 2005/06, you need to make your AVCs by 5 April 2006. You cannot catch up on AVCs that you have not made in previous years.

Employees (not controlling directors) with P60 earnings of £30,000 or less in any of the years from 2000/01 to 2004/05 could pay up to £3,600 gross into a personal pension as well as, or instead of, making AVCs.

Self-Employed People

Business tax planning is usually best done before the end of the accounting period, but for many people this is nearly the same as the tax year, so this could be a good time for self-employed people and members of partnerships to consider tax-saving opportunities on business profits as well.

■ Businesses that perform service contracts over a period will generally have to recognise income earlier, under a new accounting practice known as UITF 40. Essentially this means that much of your work in progress will now be valued at 'selling price' rather than cost so that it includes your profit. This could well mean a higher than normal tax bill this year. One way to help your cash flow could be to invoice customers earlier and more frequently.

■ It might be worth accelerating any allowable expenditure you already had planned, such as on repairs, so that you benefit from the tax relief earlier.

■ Much capital expenditure can qualify for tax relief. For example, small businesses qualify for a 40% first-year allowance on the cost of most equipment. This will rise to 50% for one year from April.

■ Check what expenditure does and does not qualify for allowances.

■ Consider whether to dispose of cars and other equipment before or after your accounting year end. It could affect your tax payments.

■ You might find that a change of accounting date will allow you to use up any overlap relief before inflation further erodes its value.

Directors and Employees

Even though tax is deducted from your income before you receive it, there are still possibilities for saving tax.

■ As a shareholding director, you might be able to choose between a bonus and a dividend – and whether you receive it before or after the end of the tax year – depending on your tax rate in each year.

■ If your company's profits are below £50,000, paying dividends before 1 April 2006 will probably increase the company's tax. From 1 April small companies will pay a flat 19% tax and dividends will make no difference to the company's corporation tax rate. So consider the company's and your personal tax in deciding the timing of dividends.

■ If your business is affected by the personal service company rules (IR35), you need to calculate how much salary to draw before 6 April 2006 if you want to avoid being taxed on a 'deemed payment'.

■ If you are going to work abroad for over a year you should probably try to leave the UK before 6 April 2006. You need to be away for a whole tax year for the income from working abroad to be free of UK tax.

■ If you hold share options, you should consider your tax as well as the investment issues when deciding whether to exercise the options now or later.

■ This is a good time to review whether it is worthwhile having a company car and, if so, whether your employer should provide fuel for private travel.

Couples and Partners

Some couples could save tax by switching income from one partner to the other. You should aim to use up both partners' personal allowance (£4,895 in 2005/06) and minimise higher rate tax. There are several ways you can transfer income between partners effectively. In most cases you do not have to be married or in a civil partnership.

■ You could transfer investment income – at least for future years – by switching ownership of the asset that produces it, although there could be capital gains tax if you are not married or in a civil partnership.

This could also save capital gains tax when the assets are sold, if one partner generally pays tax at a lower rate than the other or is likely to have an unused annual exemption or capital losses. You should leave as much time as possible between the transfer of the assets and their sale.

■ If you are in business, you could pay a lower-income partner a salary, on which you would get tax relief. You will not need PAYE records if the salary is below the national insurance contribution (NIC) limit of £356 a month in 2005/06. But if the salary is between £356 and £408 a month your partner will qualify for state benefits, such as the retirement pension, without paying any NIC. The remuneration must be justifiable in relation to the work done.

■ As well as salary, you can pay up to £3,600 in 2005/06 as an employer's contribution to your partner's personal pension plan. There is no tax or NIC on the payment and it would normally be an allowable business expense.

■ You could share the profits of your business by operating as a partnership. You both need to be genuinely involved as business partners, though not necessarily equally, have a joint business account and ideally have a written partnership agreement.

■ Your partner could be a

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Children

Children can have tax-free income of up to £4,895 in 2005/06. However, income of more than £100 derived from a gift from a living parent is taxed as the parent's income if the child is under 18 years and unmarried.

■ Older teenagers could work in a parent's business for a reasonable salary.

■ Where a child is a beneficiary of a discretionary or an accumulation and maintenance trust, the trustees could distribute some income and the child could reclaim some or all of the 40% tax paid on the distribution.

Child trust fund

Do not forget that you can add £1,200 a year to a child trust fund for children born after 31 August 2002, though this allowance is not for the tax year but for each 12 month period since the child's birth.

Child tax credit

The government pays child tax credit of £545 for each family direct to the main carer. The amount is £1,090 where there is a baby up to a year old. Normally the tax credit is reduced by £1 for every £15 of joint income over £50,000. If you have a child and you are not claiming tax credits, you should keep your income and circumstances under review. You cannot backdate a claim by more than three months.

Taxpayers Aged 65 or Over

If you have reached the age of 65 by 5 April 2006, you may qualify for a higher personal allowance. You might also qualify for a married couple's allowance if at least one partner in a marriage or civil partnership was born before 6 April 1935.

The extra allowances are reduced in 2005/06 by £1 for every £2 of taxable income above £19,500. Reducing your income to this level could save tax at an effective rate of up to 33%.

One way of doing this, if you are under 75, is to make personal pension contributions of up to £3,600 (before deducting tax relief). You do not need any earnings. You could even draw the pension immediately, including a 25% tax-free lump sum.

Other possibilities are transferring investments to your partner (provided this does not reduce their allowances) and switching into investments that generate capital growth.

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shareholder in your company and receive dividends. The 10% tax credit on dividends cannot be recovered; so your partner would also need non-dividend income to benefit from the personal allowance.

In a landmark ruling, the Appeal Court recently gave the green light to this strategy, rejecting attempts by HMRC to tax the working partner on dividends paid to both.

■ You could simply transfer savings into your joint names so that half the income is taxed on each partner.

Inheritance Tax

A growing number of estates are now caught by inheritance tax (IHT) – payable if a person's assets at death plus gifts made in the seven years before death add up to more than £275,000. There are some reliefs and exemptions and most planning is not linked to the tax year end.

■ Gifts of up to £3,000 in a tax year are exempt from IHT. If you made no gifts to use this exemption in 2004/05, you can make IHT-free gifts of up to £6,000 before 6 April 2006.

■ Regular gifts out of excess income could also be exempt. You need careful documentation to prove that you made the gifts from income rather than capital.

■ If IHT planning in the past has left you liable to income tax on 'pre-owned' assets, consider whether you could save money by paying something for the benefit you receive – eg rent on the property you gave away but continue to live in. This is a complicated area and you should obtain specialist advice.

Investment Income

It might be worth bringing forward your investment income into this year by closing an account before 6 April 2006, especially if you are a basic rate taxpayer now but are likely to pay higher rate tax in 2006/07.

If you are already a higher rate taxpayer, you might be able to save tax at 42% by making a personal pension contribution if this means some of your interest is no longer subject to higher rate tax. The reduction consists of the 20% difference between the 40% and 20% tax rates on interest and the 22% basic rate tax relief deducted from the pension payment. The saving is 44.5% on dividend income.

Capital Gains Tax

If you have investments, such as shares or unit trusts, try to use your annual capital gains tax (CGT) exemption. This year, you can realise total net profits of £8,500 after deducting any allowable losses you have realised during the year. You generally realise a gain or loss by either selling the investment or giving it away, though not to your husband, wife or partner.

If you are keen to retain your investment, selling it and then immediately buying it back is no longer effective for tax purposes, but you could buy it back in your ISA, or your partner could buy it back, or you could repurchase a very similar investment.

If your disposals this year have resulted in an overall loss, you can carry this loss forward and set it against any gains that exceed the annual exemption in future years.

Taper relief

Taper relief reduces the amount of a taxable gain.

■ On your business assets, you qualify for the maximum taper relief after you have owned them for at least two years. At that point only 25% of the gain is taxable. The combination of this taper relief and the annual CGT exemption can mean that many gains on business assets will be tax free. If any gains remain taxable, the maximum effective rate of tax after the relief is only 10%. Business assets include shares in the company that employs you as well as assets used in a business and shareholdings in unlisted companies.

■ Other assets qualify for taper relief at the rate of 5% a year starting from the third year of ownership. If you owned an investment on

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Tax-Efficient Investments

Some investments have income tax and CGT advantages.

Individual savings accounts (ISAs)

■ You can invest up to £7,000 in an ISA each tax year. There is a choice of investments, including equities and fixed interest securities, although the amount you can invest in cash each year is generally limited to £3,000. 16 and 17 year olds can open a cash ISA, so you may wish to provide funds for children or other young relatives to invest.

Enterprise investment scheme (EIS)

The EIS gives tax relief for investing in new shares in qualifying trading companies that are not listed on the Stock Exchange. The tax privileges granted to EIS investments are intended to compensate for the very high risks that are typically associated with them.

■ Income tax relief is given at 20% on up to £200,000 invested in a tax year.

■ Gains escape CGT after three years.

■ It is possible to defer CGT on a gain of any size on a disposal of any asset by reinvesting in shares that qualify under the EIS.

Venture capital trusts (VCTs)

You can obtain income tax relief of 40% by subscribing up to £200,000 for shares in VCTs in 2005/06. Next year, the tax relief is due to revert to 20%. Gains are generally exempt from CGT. VCTs are investment trusts that invest in a range of companies. As with EIS, the tax advantages are intended to counterbalance the typically very high investment risks associated with VCTs.

Enterprise zone investments

You may still be able to find some enterprise zones (EZ) where full tax relief is available on investment in new commercial buildings, although supply is very limited. You have to invest by 5 April 2006 to qualify for tax relief in 2005/06. If you borrow the money for the investment, the interest can be offset against rental income.

It is important to remember that EIS, VCT and EZ are all high risk investments and may be difficult to realise.

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17 March 1998, it should qualify for an extra 5%. It takes 10 years' ownership to qualify for the maximum 40% relief. It may be worth postponing the sale of an investment to qualify for extra taper relief. For example, if you can delay the sale of an asset you owned on 17 March 1998 until 6 April 2006, your taper relief will increase from 30% to 35%.

Payment of CGT

CGT is payable on 31 January following the end of the tax year in which the disposal took place. You might want to delay a major sale until after 5 April 2006 to give yourself an extra 12 months before you have to pay the tax.

Negligible value claims

An asset which you still own might have become virtually worthless. If so, you can claim the loss against your capital gains. The time limit for backdating a claim to 2003/04 for assets that had become of 'negligible value' in that tax year is 5 April 2006.

Charitable Giving

■ You can get tax relief for any gifts to charity if you make a gift aid declaration. You deduct tax at 22% from the gift and the charity benefits by claiming this tax back. Higher rate taxpayers can claim extra tax relief of 18%.

■ You can elect for donations made in 2005/06 to be treated for tax purposes as if they had been made in 2004/05. This will benefit you if you were a higher rate taxpayer in 2004/05 but not in 2005/06. The election must be made in writing with or before filing your 2004/05 tax return and this must not be later than 31 January 2006.

You can obtain both income tax and capital gains tax relief on gifts of listed shares and certain other investments to charity.

Conclusion

This brief review of end of year tax planning can only cover the main areas in outline. Although saving tax is important, there are other factors to consider:

■ Making sure you have enough money to meet your personal and business needs.

■ Ensuring that any investment meets your needs in terms of risk and potential profitability.

■ Some tax-saving actions involve risks.

■ Flexibility is almost always desirable, even if it involves costs or saves less tax.

■ The costs and inconvenience of implementing some tax-saving strategies might not always be worthwhile.

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