Tax Plus

mercer & hole
chartered accountants

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Welcome to Mercer & Hole's special Budget edition of Tax Plus.

Penny pinching on pensions!

It has long been expected that the rate of tax relief on pension contributions would be restricted to the basic rate for higher earners. This has now been announced to come fully into effect from 6 April 2011. However, there are some interim measures that apply immediately. The key points of the new rules are set out below.

New regime from 6 April 2011

With effect from 6 April 2011, the Government plans to restrict the income tax relief on pension contributions for anyone with taxable income of £150,000 or more.

Tax relief will be tapered down for those with incomes between £150,000 and £180,000 so that effectively it will be worth 20% for incomes over £180,000, which is the same as it is for a basic rate taxpayer.

Example 1

Brian has income of £145,000 in 2011/12 and makes pension contributions of £50,000.
He will obtain higher rate tax relief on his contributions as his earnings are less than £150,000.

Example 2

Angela has income of £190,000 in 2011/12 and makes pension contributions of £50,000.
She will obtain basic tax relief only as her income exceeds £180,000.

Special Annual Allowance (applies from 22 April 2009 to 5 April 2011)

Between 22 April 2009 and 5 April 2011 special provisions will apply. Tax relief on contributions will be limited for individuals:

- with income in excess of £150,000 in the tax year, or any of the preceding two tax years; AND
- who increase the level of their regular ongoing pension contributions from the levels before 22 April 2009; AND
- who make total pension contributions in excess of £20,000 in the tax year.

For such individuals a "special annual allowance" will apply to set a limit on the pension contributions paid in the tax year that will obtain maximum tax relief. This allowance will be the greater of £20,000, or the "protected pension input". The protected pension input is the level of the regular ongoing pension contributions as established before 22 April 2009 (as below). Tax relief on pension contributions above that level will be restricted effectively to the basic rate by the application of a special annual allowance tax charge to recover the tax relief obtained above the basic rate of tax relief.

It is only necessary to review whether the protected pension input applies where you have already been making regular ongoing pension contributions before 22 April 2009 of more than £20,000. If you have, then this provision will be potentially very valuable as this will set the limit on the pension contributions on which you can obtain higher rate tax relief in the period from 22 April 2009 to 5 April 2011.

Regular ongoing contributions are the normal level of your pension contributions that you have made at *least on a quarterly basis* before 22 April 2009. This means that regular annual lump sum payments would not count towards the protected pension input.

To explain, if you have made regular monthly pension contributions totalling £30,000 in 2007/2008 and 2008/2009, this should count as your protected pension input. This would mean that you could contribute another £30,000 on this basis in 2009/2010 that would not exceed the protected input and would qualify for maximum tax relief.

See more examples **...continued**

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Example 3

David has income of £160,000 in 2008/09 and £145,000 in 2009/10 and makes pension contributions of £15,000 and £25,000 in the respective years.

He is subject to the special annual allowance tax charge in 2009/10 as his income exceeds £150,000 in the preceding tax year. As his pension contributions made in the year exceeds £20,000. The charge applies to the excess of £25,000 over £20,000.

Example 4

Ann has income of £200,000 in 2009/10. She made regular monthly pension contributions totalling £50,000 in the year exactly the same as she did in 2008/09.

She is not subject to the special annual allowance tax charge as although her income exceeds £150,000 and total contributions exceed £20,000, she has not increased the level of her regular contributions.

Example 5

Paul has income of £160,000 in 2009/10. He makes a pension contribution of £15,000 in the year, having made no previous contributions.

He is not subject to the special annual allowance tax charge because whilst his income exceeds £150,000 and he has increased the level of his regular contributions, his total contributions are less than £20,000.

There are many points of detail in these interim rules and therefore each individual case would need to be considered on the basis of all relevant facts.

It should also be stressed that these special rules fall away from 6 April 2011 and, from that date, the limit of £20,000 and the concept of protected pension input disappears. No higher rate tax relief will be available where earnings exceed £150,000.

Racking up the rates

Changes were announced which will apply to income tax rates and personal allowances after 6 April 2010:

Individuals

An additional higher rate of income tax of 50% will apply for individuals on their taxable income over and above £150,000. Not only is this higher than the 45% tax rate initially announced last year but it will come into effect one tax year earlier than expected.

The maximum special rate of tax on dividends will similarly increase from the present 32.5% to 42.5%.

These increases will exaggerate the existing differential between income tax and capital gains tax rates. Because the capital gains tax rate remains at 18% this distinction may influence individuals as regards future investment policies. The differential also raises issues as to how best to arrange the division of income amongst family members.

The timing of the increase may present a planning opportunity to accelerate income receipts so they fall into the current tax year.

Trusts

The rate of income tax payable by discretionary trusts will follow the pattern and increase to 50% or 42.5% for dividends. For trusts, these rates apply to all income not just the surplus over £150,000.

Beneficiaries may be able presently to reclaim the tax credit on the amount they receive which represents the tax paid by the trust but there is a time lag. As a result, the increases may significantly affect the distributions and cashflow of the trust and beneficiaries.

It is worth bearing in mind that the trust rate applies to discretionary trusts, so it may be worthwhile trustees considering a revocable life interest trust or other alternative strategies which could mitigate this disadvantage.

Loss of personal allowance

The basic personal allowance, which for 2009/10 is £6,475, is the amount of income most individuals can have before paying any income tax. From 6 April 2010 the allowance will still be available where income is less than £100,000.

Where income exceeds £100,000, the allowance will be reduced by £1 for every £2 that the income limit is exceeded. We do not yet know the level of the personal allowance for 2010/11 but on the basis of current levels, the allowance could be eliminated when income exceeds £112,950.

Sun sets on holiday lets

There was some bad news for owners of properties that currently qualify as Furnished Holiday Lets (FHL). The beneficial treatment that such properties attract will no longer be available from the 2010/2011 tax year.

Currently, let properties in the UK, which fulfil the necessary conditions to qualify as an FHL, attract the beneficial tax treatment. Broadly, the conditions are that:

- the business must be carried on commercially, and with a view to a profit;
- the property must be available for commercial letting as holiday accommodation to the public for at least 140 days during the year;
- the property must be commercially let as holiday accommodation to members of the public for at least 70 days during the year (not more than 31 days to the same person).

The benefits of this treatment are that landlords are treated as though their qualifying FHL business is a *trade* for the following purposes:

- loss relief;
- capital allowances;
- Landlords Energy Saving Allowance (LESA);
- certain capital gains reliefs and relevant earnings when calculating the maximum relief due for an individual's pension contributions.

The change is being brought about because of European Law, and the only good news is that the beneficial treatment should be extended to properties within the European Economic Area for the short period until next April. There is an element of backdating as well. This means that it is possible to submit amended tax returns and claim refunds in some cases:

- returns that are still within the normal time limit for amendment can be made within that time limit;
- HMRC will also accept late amendments to personal tax returns for 2006/2007 and corporation tax returns for periods ending after 31 December 2006.

The deadline for making a late amendment is 31 July 2009. It may be possible to make claims for earlier years in some circumstances.

Probably the two most likely areas to consider making a claim are loss relief and capital gains tax.

Example 1

George owns a villa in Spain at which he spends only two weeks a year. For the rest of the holiday season it is let and fulfils the conditions to qualify as FHL. Because the villa was bought with a large mortgage the income does not cover the interest and George makes a loss in 2006/2007 and 2007/2008.

George is now able to make a claim to set the losses for both these years against his other income and get a tax refund. He needs to amend his 2006/2007 return by 31 July 2009 and his 2007/2008 return by 12 months after the date he submitted it.

Example 2

Susan owned a property in Italy for three years before she sold it in March 2007. Had the property been in the UK it would have qualified as FHL. She realised a gain of £100,000 on the sale and paid tax of £40,000. She should now revisit her tax return and consider claiming business asset taper relief on the sale. If full relief is available she would be due a refund of £30,000. She must amend her return by 31 July 2009.

Bigger breaks for business

A number of short-term measures to help business have been announced; the main ones relate to capital allowances and loss relief.

Capital allowances

First year allowances on purchases of qualifying plant and machinery have been resurrected for expenditure incurred in the year to 31 March 2010 for companies, and to 5 April 2010 for partnerships and individuals.

It was only one year ago that the old first year allowances were abolished and replaced with an annual investment allowance giving 100% relief on the first £50,000 of eligible additions. To encourage businesses to invest in new capital equipment a 40% allowance will be available on costs in excess of the annual investment allowance.

The 40% allowance will not apply to certain categories of assets including, for example, long life assets, cars and assets held for leasing. However, businesses can choose which assets are to be covered by the annual investment allowance and so the eligible additions can be set against the different allowances to give the most favourable outcome.

Unusually, there appears to be no restriction on the amount of the expenditure or the size of business incurring the costs.

Loss relief

On trading losses, the normal rule is that losses can be carried back and set off against the profits of the previous year. With the onset of the recession many businesses did not have sufficient profits to make use of their losses in this way. To help business in acknowledged difficult times last year, it was announced that losses of up to £50,000 could be carried back for three years. This applied to losses made in company accounting periods ending in the period 24 November 2008 to 23 November 2009 and for unincorporated businesses for 2008/09.

This three year carry back is to be extended for a further year, for company accounting periods ending in the period 24 November 2009 to 23 November 2010 and for 2009/10 for unincorporated businesses. The extension will again be limited to £50,000, giving a total of £100,000 over two accounting periods. The losses will be offset against later years first.

Inheritance tax

Although much feared, there were in fact no withdrawals of the valuable inheritance tax reliefs for agricultural property and business interests - namely Agricultural and Business Property Relief.

The Budget even went as far as to announce an extension to the circumstances in which executors and trustees may claim inheritance relief for agricultural property and woodlands to now include land in the European Economic Area (EEA).

Historically, the relief has been limited to property in the UK, the Channel Islands or the Isle of Man. The extension of the relief takes effect immediately but can also apply to circumstances in which inheritance tax was paid on such property on or after 23 April 2003. It will be possible to reclaim any overpayments but the earliest opportunity to do so is only after 21 April 2010.

There were no increases to the inheritance tax nil rate band other than as previously announced. From 6 April 2009 the nil rate band is £325,000.

For further information please call your normal contact at any of the offices below.

St. Albans
Gloucester House
72 London Road
St. Albans
Hertfordshire
AL1 1NS

Tel: (01727) 869141
Fax: (01727) 869149
stalbans@mercerhole.co.uk
DX: 6121 St. Albans

London
International Press Centre
76 Shoe Lane
London
EC4A 3JB

Tel: (020) 7353 1597
Fax: (020) 7353 1748
london@mercerhole.co.uk
DX: 469 London/Chancery Lane

Milton Keynes
Silbury Court
420 Silbury Boulevard
Central Milton Keynes
MK9 2AF

Tel: (01908) 605552
Fax: (01908) 677433
miltonkeynes@mercerhole.co.uk
DX: 54467 Milton Keynes

Northampton
300 Pavilion Drive
Northampton Business Park
Northampton
NN4 7YE

Tel: (01604) 669330
Fax: (01604) 702000
northampton@mercerhole.co.uk