



Ashley Hayman clears some of the confusion

Pensions have long been one of the mainstays of tax planning and of saving. But Alistair Darling changed all that at a stroke in his Budget this year.

#### What's the Problem?

From April 2010, the top rate of income tax, for those with income over £150,000, is going to be 50%. You may think that's an opportunity too good to miss: tax relief on pension contributions at 50%. Alas, the Chancellor thinks that's an opportunity too good to allow! So pensions tax relief is to be cut back. Full details are not yet available, but for those with income over £180,000, relief will be limited to 20%.

Tax relief at 20% is actually worse than it sounds. Pension benefits typically comprise a tax-free lump sum, 25% of the fund value, and a taxable pension, 75% of the fund value. So 75% of the pension fund may eventually be taxed at 40% or 50%. It is the same as if the whole pension fund is to be taxed at 30% or 37½%. So your pension fund could suffer more tax

# PENSIONS? WHAT'S THE PROBLEM?

on the way out than the tax relief you gained on the way in!

#### OK. What's the Solution?

Well, there is a limited and short term solution. The new 20% limit does not start until April 2011. So why not make extra contributions between now and then, with tax relief at up to 40%? Why not indeed? Well, actually, the Chancellor has thought of that one. There is a special restriction between April 2009 and April 2011. For those earning over £150,000, there is generally a limit

of £20,000 on contributions that qualify for full tax relief. But this transitional regime does contain four opportunities – and one trap!

First, the trap. The £150,000 limit will catch you if your income exceeds £150,000 in this tax year or did so in either of the previous two tax years. And the same three-year rule will be applied next year too. What income counts towards the £150,000? The rules are complex, but all income is included: not just your professional income but any income from other sources such as property



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or investments. You can deduct gift aid payments. And, strangely, you can also deduct personal pension payments up to £20,000!

Therein lies the first opportunity. If your income is up to £170,000 you can make pension contributions to bring the total back down to £150,000 and thereby qualify for full tax relief.

The second opportunity is for those whose income does not exceed £150,000. (But remember the three-year trap!) For you, it's open house until April 5, 2011. You should consider making pension contributions to the full extent you can afford. But do also consider some of the alternatives below.

The third opportunity has actually been and gone. If you had already paid contributions over £20,000 before Budget day, ie, between April 6 and 21, they still qualify for full tax relief.

The fourth opportunity is for those who were already making pension contributions over £20,000pa before Budget day. If you were paying by regular monthly or quarterly contributions, you can carry on paying the same amounts (on the same policies) until April 5, 2011 with full tax relief. If you were paying regular annual contributions, the limit is £30,000 but you are also limited to the average of the last three years' contributions.

#### Employed Barristers

If you are an employed barrister, here's a few extra twists for you! Salary sacrifices are generally a good idea. You give up salary in exchange for an extra employer pension contribution, and you both save national insurance contributions. But, when looking at the £150,000 limit that applies until April 2011, you have to ignore any such salary sacrifice arranged after April 21, 2009. If your pension contributions are based on a percent-

age of salary then they can rise in line with any salary increase, even beyond the £20,000 limit. You do get the £30,000 limit for an established average level of annual contributions, but with this difference: contributions to final salary schemes do not count towards an established level.

Here's a real twist: Tax relief at 20% is achieved by giving you full tax relief, at 40% or 50%, and imposing a separate tax charge at 20% or 30%. If the offending pension contribution is an employer contribution, you will pay 20% or 30% tax even though you have received no extra cash!

#### What About Alternatives?

Let's consider what we are trying to replace. Pension policies are a tax-efficient way of saving for retirement. There is tax relief on the contributions. The funds in the policy grow tax-free. The funds in the policy are generally outside your estate for inheritance tax purposes. 25% of the eventual value of your pension savings can be taken as a tax-free lump sum. (But 75% must be taken as a taxable pension.)

Because of these tax privileges, there are also restrictions. These include:

- An annual limit on contributions, currently £245,000 but due to rise to £255,000.
- A lifetime limit on the value of pension savings, currently £1.75m but due to rise to £1.8m.
- Pension benefits cannot be drawn until age 50, due to rise next April to age 55.

There is no precise alternative. If there were, it would be a pension policy! But what we are looking for are other investments with tax privileges and acceptable restrictions.

#### Investing for Capital Gains

There is no tax relief on making ordinary investments, say in

stocks and shares or unit trusts. Gains are subject to capital gains tax at 18%. But each individual has an annual exemption for gains up to £10,100. That's £20,200 for a couple. So investing for capital growth may well be part of your planning.

#### Individual Savings Accounts (ISAs)

There is no tax relief on investing in ISAs. But dividends are free from income tax and gains are free from capital gains tax. Each individual can invest up to £7,200pa in an ISA. That will rise to £10,200 from April 2010, but individuals aged over 50 in the current tax year may invest £10,200 in an ISA this year. ISAs can be used to build a tax-free portfolio. There are no age restrictions on cashing in ISAs. So ISAs should probably form part of your planning.

#### Venture Capital Trusts (VCTs)

VCTs are quoted companies that themselves invest in unquoted trading companies. They enjoy tax privileges because they channel investments into a favoured sector of the economy. Those tax privileges include:

- Income tax relief of 30% on VCT investments. When pensions tax relief drops to 20% for those on the highest incomes, VCT investment will attract higher tax relief. But note that the tax relief cannot exceed the tax you would otherwise have paid.
- VCTs pay no tax on their own capital gains.
- Dividends paid to investors are free from income tax.
- After five years, individual investors pay no capital gains tax if they make gains on their VCT investments.
- Each individual has an annual investment limit of £200,000.
- There is no lifetime limit.
- There are no age restrictions on cashing in VCTs.

So in many ways, VCTs enjoy more attractive tax breaks than pensions. With good advice, they should be seriously considered as an alternative.



### Enterprise Investment Scheme (EIS) investments

The Enterprise Investment Scheme offers tax incentives to individuals to invest in unquoted trading companies. The incentives include:

- Income tax relief of 20% on EIS investments. But note that the tax relief cannot exceed the tax you would otherwise have paid.
- Capital gains tax deferral on gains made in the last 36 months, up to the amount invested. Deferred gains are taxed at the rate applying when the EIS investment is encashed; so it may be possible to defer a gain that would have been taxed at 40% (in 2007/08) and have the deferred gain taxed eventually at 18%.
- After two years, EIS investments are effectively free from inheritance tax.
- After three years, individual investors pay no capital gains tax if they make gains on their EIS investments.

- Each individual has an annual investment limit of £500,000.
- It is possible to use an unused annual limit in the following year, so an individual may be able to invest up to £1,000,000 in a year.
- There is no lifetime limit.
- There are no age restrictions on cashing in EIS investments.

So in many (but not all) ways, EIS investments also enjoy more attractive tax breaks than pensions.

### Aren't These Investments Risky?

Investing in anything may be risky. Investors have come to realize that pension policies are only tax-favoured wrappers around ordinary investments – and that the value of those investments can fall as well as rise! A good adviser will tailor investments to suit an investor's age, circumstances, and risk profile. Of course there are high-risk VCTs and EIS investments. But there are also VCTs and EIS investments designed as low risk, with

features that effectively guarantee up to 75% or even 95% of your capital.

### But I'm Still Going to have a 50% Tax Problem!

Well, although pensions are no longer the answer, there may be other solutions. But that lies outside the scope of this article.

### Confused?

You should be. Some advisers are! This article could not explain everything you need to know. The importance of good tax and financial planning advice cannot be stressed too strongly. ❖

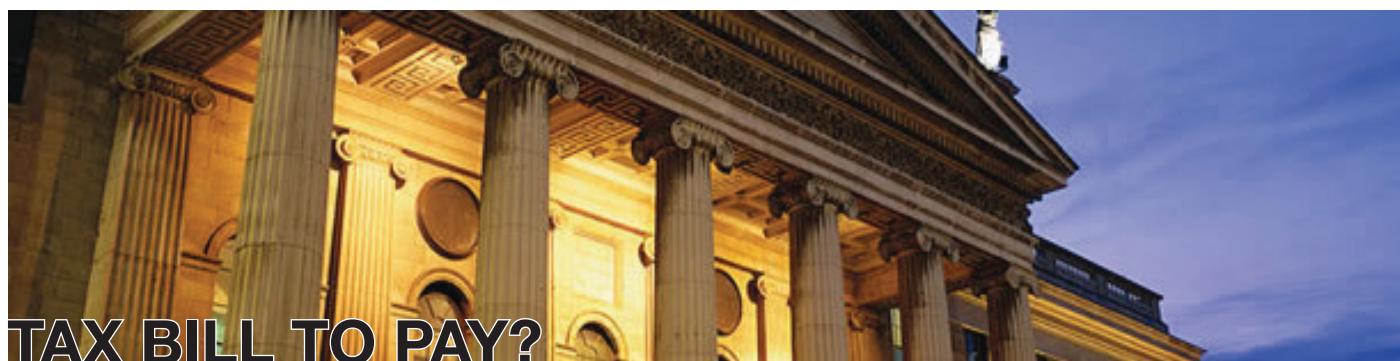


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