A budget for families?

Introduction

Well it is a different way of looking at the Coalition Government's emergency budget on June 22nd. Some may disagree with this sentiment but at TRH our job is to plan the financial affairs of our clients. As such, we cannot help feeling that the tax regime we have for 2010/11 gives significant planning opportunities to those who are married or in civil partnerships and, or, have trusting relationships with their parents and children.

Although tax increases are never welcome, we are pleased at last to have some certainty in the new tax regime. This allows us to review a client's financial planning situation to ensure as much tax efficiency as possible.

Income tax

Fortunately, no real change here from what we already knew for 2010/11. The £1,000 increase in the personal allowance happens in tax year 2011/12 (although this does not benefit higher rate tax payers!). Now we have some certainty over the rules for this tax year, we can continue with the tax planning we have already started with many of our clients. Incredibly, we now have effectively seven different tax bands. With some careful planning families can take advantage of these. The bands are:

Income Band £	Tax Rate
0-6,475	0%
6,475 – 8,915	10% (savings only)
6,475 – 43,875	20% (10% dividends)
43,875 – 100,000	40% (32.5% dividends)
100,000 – 112,950	40-60%* (32.5% dividends)
112,950 – 150,000	40-60%* (32.5% dividends)
Over 150,000	40-60%* (42.5% dividends)

* The personal allowance is withdrawn by £1 for every £2 of income over £100,000. For this reason, depending upon the income level, the effective rate of tax may be as high as 60%.

Trusts will pay the top rate of 42.5% on all dividend income over the trust nil rate band.

The main planning opportunity here is to shift income between spouses, and sometimes even children, to take advantage of a lower tax rate than the income would otherwise suffer. Every individual has a personal allowance, even children, and simply moving £6,475 of income from a 50% band to a spouse with no income will save £3,237.50 in tax. The same planning principles can be applied to each tax band but two are worth focusing on:

- Maximising income up to £43,875 in each spouses name to utilise fully the basic rate tax band. Moving income from a 50% liability to somebody with no taxable income can save nearly £14,500 in tax.

- Avoiding the effective tax band of up to 60% that hits due to the withdrawal of the personal allowance for those with income between £100,000 and £113,000

Some examples of income tax planning we are already implementing using inter spouse transfers of ownership are:

- Transferring cash to the spouse with the lower tax rate, although with the current low interest rates that sometimes only provides a marginal benefit.

- Transferring ownership of investment property and private property companies. This can produce real savings where the rental or dividend income is substantial.

- Transfer of equity in family/private companies. The spouse with a lower tax rate can then receive a dividend based on their shareholding. This can produce a further advantage over salary as dividends do not suffer National Insurance Contributions.

- Transferring quoted equity holdings and other income producing assets. It is worthwhile checking here when dividends are due to be paid.

- Creating bare trusts for grandchildren with gifts from grandparents. Each child can receive tax-free income up to their own personal allowance of £6,475. This can form part of a wider school fees and inheritance tax plan.

We must stress, that these are just the headline points, great care needs to be taken when transferring assets as other non-tax aspects of who owns what in a family can come into play. Any ‘gifts’ also need to be permanent in nature. The interaction of income tax planning with both capital gains tax and inheritance tax is also to be considered.

Capital Gains Tax

The increase to a top rate of 28% for higher rate taxpayers brings similar opportunities to consider spousal transfers of assets to minimise tax. In simple terms the new CGT regime works by adding the taxable gain in a tax year to the income in that year. If the total takes the taxpayer over the basic rate threshold (£43,875) the excess over that threshold is taxed at 28%. For basic rate taxpayers the rate remains at 18%.

As transfer of ownership between spouses is tax neutral for CGT. The obvious first step is to consider each spouse’s income position prior to realising gains and to make a transfer if the resultant gain plus the transferor’s income falls below £43,875 in 2010/11.

It also makes sense to hold potentially taxable assets in tax-free wrappers such as pensions and ISA’s wherever possible by utilising in full annual allowances. VCT’s also provide 30% income tax relief on investment and returns free of both income and capital gains, but the trade off is the higher risk nature of these structures.

We were of course relieved to find that the annual CGT exemption of £10,100 for individuals was, after much speculation, retained. The use of this valuable allowance allows a couple to draw tax free 'income' of £20,200 a year, perhaps more if the children are in a position to use their own allowances.

Child Trust Funds (CTFs)

The CTF is another tax wrapper but one that is often forgotten. Indeed the headlines for the emergency budget seemed to indicate that CTFs were scrapped. Not so. For children that already have a CTF it is still possible to pay £1,200 a year until the child becomes 18 and entitled to the assets in the CTF. The tax regime is similar to an ISA with gains and income accruing tax-free. Investing £1,200 a year at 5% for 18 years comes to £33,750, a useful sum to help with a first year at university or perhaps funding a gap year. Perhaps something for grandparents to consider whilst using the regular gifts out of income exemption for Inheritance Tax purposes?

Conclusion

This note aims to provide an overview of some of the tax planning matters we will be addressing in 2010/11 for our annual planning clients. We have focused on income and capital gains tax as this is where the main changes have arisen. Our annual planning program means that we are usually fully aware of our client's circumstances and we will be working on an individual basis to address the specific issues that apply to each client at our Annual Planning Meetings (APMs). If there is something you would like to discuss in the meantime please do not hesitate to contact me, Ruth, or Matt.

Gareth Marr

30 June 2010

A regulatory note