FINANCE UPDATES

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HOW TO SHIELD INCOME FROM TAXATION

Tax planning tips to keep more of your income.

“How can I legitimately reduce my tax bill” or “how can I keep more of my income” are two similar questions we get asked fairly regularly, often by clients who seek to validate how they are managing their finances.

With recent governments cracking down on tax evasion, and schemes existing that could bring you to HMRC’s attention, the answer is never straightforward and largely depends on your circumstances.

While we never advise you on ways to evade paying tax to the Revenue, there are planning strategies that might enable you to reduce what you owe or protect future gains.

Using any tax allowances to which you are entitled in the tax year and maximising contributions into pensions and ISAs would be a good place to start.

Then there’s looking at how you will take income in retirement and assessing what types of investments you have. Most people, however, don’t use all of their tax allowances to keep more of their income.

MAXIMISE ALL EXISTING ALLOWANCES

Whether deducted at source or paid through self-assessment, everyone uses their personal allowance, which stands at £12,500 in 2020/21, to reduce what they owe in income tax.

Anyone who maximised their pension contributions before former Chancellor George Osborne reduced the pension and lifetime allowances for 2011/12 would be sitting pretty today.

Back in March 2011, the lifetime allowance stood at £1.8 million and the pension allowance at £225,000. A month later those allowances were slashed to £1.5m and £50,000, respectively.

Despite drastic cuts to the lifetime allowance (£1.073m in 2020/21) and the pensions allowance (£40,000 in 2020/21), they remain tax-efficient strategies this tax year.

With the pensions allowance, it is also possible to carry forward any unused allowance from the previous three tax years to boost your entitlement for 2020/21.

While contributing towards an ISA will not reduce your tax bill, it is a way of potentially reducing your future tax bill as any income you save or invest into an ISA – up to a cap of £20,000 in 2020/21 – goes into a tax-free wrapper, shielding it from income tax or capital gains tax.

Unlike the pensions allowance, any unused ISA allowance does not roll over into 2021/22. Although given how mad this year has been, that’s not beyond the realms of possibility in the future.

If you have investments held outside of an ISA or pension wrapper, it’s worth considering your annual dividend allowance and personal savings allowance.

The dividend allowance may only be £2,000 in 2020/21, but tax rates on income from dividends are lower than the various income tax rates in play around the UK. This is a popular option for company directors.

There might also be a small tax-efficient benefit from using the personal savings allowance, which allows basic-rate taxpayers to save £1,000 of annual interest from saving tax-free. For those in the higher rate, this allowance drops to £500.

Utilising capital gains tax allowances – both your own and your spouse or civil partner's – is vital when it comes to managing investments in shareholdings outside of an ISA or pension.

However, complex new rules apply to capital gains from UK residential property in 2020/21, arguably the biggest of which requires you to report and pay any capital gains tax within 30 days of completing the sale.

MANAGING CLIFF EDGES

Wealthy people are familiar with various 'cliff edges' within the tax system. In a tax-planning context, the term 'cliff edge' relates to the consequences of breaching a certain tax allowance.

The two most common cliff edges to be aware of arrive in the form of the tapered annual allowance and the lifetime allowance. Let's tackle the taper first, which takes most high earners away from the cliff edge in 2020/21.

The taper affects how much you can put into, or accrue benefits towards, a pension and receive tax relief at your marginal rate.

If you are above both the threshold income (£200,000) and adjusted income (£240,000) figures in 2020/21, your pensions allowance will reduce by £1 for every £2 over £240,000.

This can erode your annual pensions allowance from £40,000 to £4,000 if you are fully impacted by the taper. For those in the additional-rate band, a 45% penalty awaits for breaching this.

The lifetime allowance is the total tax-free value of your pension, up to £1,073,100 in 2020/21. For the wealthiest savers, this cliff edge approaches fairly quickly meaning they require alternatives to pension savings.

One alternative is to explore enterprise investment schemes or venture capital schemes. These are more complex and carry considerably more risk than a pension, but do offer tax relief.

If you contribute to someone else's pension, perhaps a spouse or child, you gain no tax benefit but the recipient gets tax relief and the longer-term tax benefits on the assets in the pension.

This type of cross-generation planning can be beneficial if you can afford to set up savings accounts for children, for example.

COMPANY SHARE SCHEMES

If you are employed, you might be able to purchase discounted shares or share options in the business you work for. These types of company share schemes offer tax benefits, such as not paying National Insurance contributions (NICs) or income tax on their value. These benefits only apply if the shares are offered through the following schemes.

Share incentive plans (SIP)

If you buy shares through a SIP which you retain for five years, no income tax or NICs will be due on the value. You also won't pay capital gains tax on any shares you sell, assuming you keep them in the SIP until you sell them.

Save as you earn (SAYE)

SAYE lets you put away up to £500 a month, usually between three and five years at which point you can purchase shares.

Any interest and an end-term bonus are tax-free, while the difference between what you bought the shares for and what they are worth is not liable for income tax or NICs.

Capital gains tax might arise if you sell the shares, although this can be mitigated if you put the shares into an ISA after 90 days of buying them or into a pension immediately after purchase.

Company share options

This enables you to buy up to £30,000 of shares in your employer's company at a fixed price. Exactly like the SAYE, no income tax or NICs is due on the difference between what you paid for the shares and what they are worth, and capital gains tax might be owed if you sell them.

Enterprise management incentive (EMI) schemes

Employers with assets of £30m or less might be able to offer an EMI scheme to grant you share options worth up to £250,000 over a three-year period. No income tax is due if you buy the shares at market value, although income tax and NICs will be due on the difference if you bought shares at a discounted rate.

Speak to us for expert financial advice.