

Kudos technical matters



Pensions

End of Company Trading and Tax Year Opportunities - time to act is now!

In this addition we are going to look at two specific areas which are of particular current relevance, these being:

- Corporate pension and tax planning
- Individual pension planning

As always change presents opportunity and this will indeed be the case for many of your clients following the changes implemented by the previous Government and amended by the current Government in the June 2010 Emergency Budget and ratified on the 14th October 2010.

In addition to the changes there are areas which are not new, but are always worth revisiting.

There are several areas which we have identified opportunities, these are summarised below. However should you require further detail on any of these areas please contact Kudos: contact details are provided at the foot of this document.

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Corporate pension and tax planning

Company year-end pension contributions

Why would a company postpone a pension contribution by just a few days which could delay the reduction in the company's tax bill by up to 12 months?

Statistics from Companies House show that the second most popular company year-end is 31st December. As company pension contributions have to be made by the year-end to reduce the profits for that year. Postponing a pension contribution by just a few days could delay the reduction in a company's tax bill by up to 12 months.

For companies whose year-end is looming, now might be a good time to seek advice on pension funding – whilst this idea is not new we believe that it is worthy of reiteration.

As an example the accounting year end for Smiths Ltd is 31st December. The company's financial adviser has recommended that the company pays a pension contribution prior to 31st December 2010.

Jones Ltd also has a 31st December year-end, however, no pension contributions are made until early in January 2011.

Both companies have to pay their tax once a year. Smiths Ltd gains the benefit of the tax saving on its contribution on 1st October 2011. However, Jones Ltd has to wait until 1st October 2012 to gain the benefit of the pension contribution paid in January 2011. This is because the contribution has to be offset against the corporation tax bill due for the year ending 31st December 2011.



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Pension contributions need to be paid before the end of the accounting period.

By way of an example:

- ABC Ltd anticipates profits in the trading year ending 31st December 2010 of £10,000.
- They had a £400,000 profit in the accounting period ending on 31st December 2009.
- Annual pension contributions for the directors and other employees are £100,000.

If the payment is made in the accounting period up to 31st December 2010, the company will have a trading loss of £90,000. This loss can be set back against the previous year's profits, gaining a corporation tax repayment (or saving, if the tax hasn't been paid over to HMRC yet) of £26,775 (29.75% of £90,000) with no tax due for the year ending 31st December 2010.

Corporation tax and pension contributions

Whilst the temporary extension to the loss of relief has passed, the ability to use a pension contribution to create or increase a trading loss which can be set against profits in the current year, carried back one year, or carried forward indefinitely, remains.

It continues to be possible to create or increase a trading loss by making an employer pension contribution. Directors of many companies may feel that making a pension contribution during a trading period when profits are low (or a loss is made) is a pointless exercise. But trading losses may be offset against the preceding year or carried forward to set against future profits. So, as long as the company either paid corporation tax in the previous period or will be paying it in subsequent periods, tax relief will be given for pension contributions providing they are wholly and exclusively for the purposes of the trade.

Company year-end directors' remuneration planning – salaries, dividends and pension contributions

Shareholding directors are in a very special position in that they can avoid the increased national insurance (NI) charge by the very simple method of extracting profits from their businesses using dividends rather than salary or bonus. This is compounded by the impending 1% rise in National Insurance Contributions (NIC) in April 2011.

This, coupled with making a pension contribution in the same tax year as receiving a UK dividend, can save up to 52.5% tax. The key is in the way that different sources of income are brought into the tax calculation. Income is piled up in layers to decide the order of taxation. Non-savings income (e.g. earnings) is at the bottom followed by savings income (e.g. interest) with dividend income at the top.

If a pension contribution is paid, the basic-rate tax band is increased by the gross amount and this means that some, or all, of the dividend may now be taxed at a lower rate. The pension contribution obtains basic-rate tax relief at source and further tax relief by claim can be obtained against the dividend income.

This increase in NIC's coupled with the current pensions anti-forestalling provisions, presents an area where financial advice is key in meeting individual directors' specific financial needs. With careful planning the company's expenditure can remain the same with the directors' extraction rate increasing substantially.



Individual Pension Planning

How an individual may retain their personal allowance

For clients whose income is more than £100,000, making a pension contribution can help to maintain their personal allowance and obtain effective tax relief of up to 65%.

As things stand presently there will be a loss of £1 in personal allowance for every £2 of income earned over £100,000. The personal allowance is lost when earnings equal £112,950 (the personal allowance for 2010/2011 is £6,475) – giving an effective 60% tax bill on this band of income, which equates to extra tax of £2,590 - over £200 extra tax every month!

This extra tax bill can be avoided with careful planning. Individuals can reclaim their personal allowance by reducing their ‘adjusted net income’ below or equal to the £100,000 by making pension contributions and, if combined with payment by salary exchange with the company reinvesting NIC savings, significant savings can be achieved. This is best described by way of an example:

If Paula has earnings of £112,000, and no other income, in 2010/2011 she’ll not only be liable to 40% tax on the top £12,000 ‘slice’ of her salary, but will also lose £6,000 of her personal allowance (£1 for every £2 above £100,000). This amount of £6,000 will be liable to 40% tax, meaning the overall tax liability on Paula’s top £12,000 slice of salary is effectively £7,200, or 60%.

If Paula makes a personal pension contribution of £12,000 gross, her adjusted net income will be reduced to £100,000. Not only will this reduce her higher-rate tax liability, but it also means she’ll retain her full personal allowance. Paula’s effective tax relief on the £12,000 pension contribution is £7,200 (60%).

Had Paula taken this a step further and remitted her contributions by salary exchange, the benefit would have been even greater due to NIC savings. Paula could have arranged a salary exchange of £12,000. However, a salary exchange of a little more at £12,204 to bring her salary down to £99,796 would mean her net income would have remained the same as it would’ve been if she’d paid the pension personally, at £65,191.

This reduction in salary would have saved the employer NIC of £1,562, meaning should they re-invest that with the exchanged salary the overall contribution would be £13,766. Paula’s effective tax relief on the £13,766 pension contribution (for a reduction in take home pay of £4,800) would have been 65%.



Last chance for individuals to contribute in excess of £50,000 - or is it?

With the impending reduction in the Annual Allowance from £255,000 for 2010/11 to £50,000 for 2011/12 there is a limited opportunity for individuals to pay contributions up to £255,000.

Under the anti-forestalling regime, which will last to the end of the 2010/11 tax year, anyone with relevant income of less than £130,000 in the current and previous two tax years can personally contribute up to 100% of their relevant UK earnings with full tax relief. This is provided the input period ends before 6 April 2011. Or an employer could contribute to the individual's pension plan, an amount up to the current annual allowance (£255,000 in 2010/11) without the individual suffering any tax charges. Those on relevant incomes higher than £130,000 may have their tax relief restricted.

As an example take Ian, who has earnings of £90,000, with earnings in the past three years not exceeding £130,000. Ian is not caught by the anti-forestalling restrictions and could pay a personal contribution of up to £90,000 in 2010/11 with full tax relief or his employer could pay a contribution of up to £255,000 without Ian having any tax consequences on that payment - provided the input period ends before 6 April 2011. However, for 2011/12 (for input periods that end from 6 April 2011 onwards) the maximum contribution with full tax relief and no tax charges for Ian will be the reduced annual allowance of £50,000.

So 5th April 2011 is the last chance for Ian to tax-efficiently pay a contribution, or have a contribution paid by his employer, of more than £50,000.

One considerable concession introduced is the ability to utilise unused allowance in the form of carry-forward of up to three years previous unused allowances. This is intended to ease or smooth out large one-off spikes in accrual that exceed the annual allowance in a single year. The carry-forward limit for 2008/2009, 2009/2010 and 2010/2011 will be £50,000 therefore if an individual was a member of a UK registered pension for the period from 2008 and made no contributions, they could contribute £200,000 in this tax year with careful planning.

The opportunity to carry forward unused allowances is particularly useful in circumstances where high earning individuals have had to restrict contributions in the two tax years up to April 2011 so as not to fall foul of the anti-forestalling legislation. This change will allow many individuals to pay increased pension contributions after April 2011 to help make up for any potential shortfall incurred as a result of the anti-forestalling legislation.

Should you require further detail on any of the opportunities referred to above please contact either Cameron Millar or Andrew Eason on 01224 652100.

Every care has been taken to ensure that this information is correct and in accordance with our understanding of the law and HM Revenue & Customs practice, which may change. However, independent confirmation should be obtained before acting or refraining from acting in reliance upon the information given. The above should be seen as information only and should not be construed as advice.

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Summary

In view of the significant changes for pensions both at corporate and individual level including such things as the reduction in the Annual Allowance from £255,000 to £50,000, the ability to utilise unused Annual Allowances and the increase in NIC's by 1%, coupled with the ongoing opportunities for companies and individuals, there has never been a greater need for careful and considered pension planning.

due diligence
employee benefits
wealth management

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