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# 50% tax - Practical ideas to mitigate the effect

As has been widely reported, the Chancellor sprang a number of surprises in this year's Budget. Not only has he brought forward proposals which were to take place in 2011, he has also made changes to his original announcements.

## The personal allowance restriction

From 6 April 2010, the personal allowance will be subject to an income limit of £100,000. An individual's personal allowance will be reduced by £1 for every £2 of adjusted net income above the income limit. The personal allowance will be reduced to nil from this income limit instead of the proposed two stage reduction announced in 2008.

Adjusted net income for these purposes is broadly all income after adjustment for pension payments, charitable giving and relief for losses.

### The higher higher rate

Instead of introducing a 45% top rate of tax in 2011, a new rate of 50% income tax will be introduced from 6 April 2010. This will apply to taxable income above £150,000.

Dividend income is currently taxed at 10% where it falls within the basic rate band and 32.5% where liable at the higher rate of tax. A new rate of 42.5% will be introduced for dividends which fall into the income band above £150,000.

**Example**

The effect of the basic changes can be illustrated as follows (this assumes that the basic rate band remains unchanged):

| | 2009/10 | | 2010/11 | |
|---|---|---|---|---|
| | | tax | | tax |
| | £ | £ | £ | £ |
| Non dividend income | 200,000 | | 200,000 | |
| Personal allowance | (6,475) | | Nil | |
| Taxable income | 193,525 | | 200,000 | |
| Taxable at 20% | 37,400 | 7,480 | 37,400 | 7,480 |
| Taxable at 40% | 156,125 | 62,450 | 112,600 | 45,040 |
| Taxable at 50% | | | 50,000 | 25,000 |
| Total tax liability | | £69,930 | | £77,520 |

## Pension changes

In addition, the government has announced its intention to restrict tax relief on pension savings with effect from 6 April 2011 for people with taxable income of £150,000 or more. The relief will be tapered down until it is 20%.

Legislation has been introduced to prevent those potentially affected from seeking to forestall this change by increasing their pension savings in excess of their normal regular pattern, prior to that restriction taking effect. Broadly, these forestalling measures will apply to individuals with incomes of £150,000 or more who, from 22 April 2009, change:

- their normal pattern of regular pension contributions, or
- the normal way in which their pension benefits are accrued, and
- their total pension contributions or benefits accrued exceed generally £20,000 a year. A higher limit of up to £30,000 may be substituted for £20,000 in specific circumstances.

However, the rules are potentially complex and the detail is outside the scope of this article but care should be taken when making pension contributions if income breaches the £150,000 limit in any of the three periods 2007/08, 2008/09 or 2009/10.

### Keeping below these levels

The obvious answer to avoiding these rules is to keep income below the £100,000/£150,000 limits respectively.

This brings us to the old question as to whether an existing business should incorporate. Limited companies do allow flexibility in how and when income is taken from the company and taxed on the owner. Many owner-managers of small companies will be able to forgo income if they wish to avoid the onerous tax consequences for those with higher incomes.

Incorporation may also give an opportunity to realise a capital gain on incorporation and a capital gain when the company is wound up. Capital is king, for the time being, as the rate of capital gains tax is a flat rate of 18%. Obviously, HMRC will be subjecting capital gains to increasing scrutiny in the future, as the rates of income and capital gains will be so different.

If businesses wish to accumulate rather than pay out their profits, then it may well be beneficial to incorporate so that any profits are only subject to the much lower corporation tax rates. Those accumulated profits can then be taken as a capital distribution from the company at 'retirement'.

It might also be possible to set up a company to conduct a one-off project, after which the company is liquidated, again giving a capital gain to the shareholders.

However, the tax tail should never wag the commercial dog. Please do get in touch with us if you feel that incorporation might be an option for your business.

### How can the 50% rate be deferred for the self employed?

Those running their businesses as sole traders and partnerships may want to think about changing their accounting date from, say, 30 April 2010 to 5 April 2010. This will mean that these profits will be taxed in 2009/10 and not 2010/11. A change may also allow overlap relief to be used to reduce the taxable amount.

No commercial reason usually needs to be given to HMRC for such a change but a change to 5 April 2010 will accelerate the date on which the tax needs to be paid.

### How can the 50% rate be mitigated in the future?

A further consideration could be to admit a company as a partner. The company will be taxed at the lower rates of corporation tax and remaining monies could then be accumulated

to meet future costs or extract as capital in the future. Once again, care needs to be taken when creating such a structure – for example, loss relief for corporate partners can be restricted.

### How can the 50% rate be deferred for the owner managers?

One option is to accelerate the date of bonuses/dividends to pre 6 April 2010. Once again, this may avoid the increased rates of tax but will accelerate the date the tax has to be paid.

It may be felt that the company's cash flow cannot support large payments prior to 6 April 2010 but this may well not be the case. All or most of the money extracted can be lent back to the company by crediting the shareholder's loan account. Interest could then be paid on the loan if desired.

If any employees are holding share options that will create an income tax charge on exercise, they may wish to consider exercising them prior to 6 April 2010.

## Extraction of profits from companies by owner managers in the future

For many years, companies have provided flexibility for owner managers in how profits are extracted. Certain benefits are not taxable or liable to National Insurance (NI), such as childcare vouchers, and the costs are usually tax deductible to the company. Employer pension contributions are also usually tax and NI efficient. These forms of planning continue.

Post 6 April 2010, some might consider making use of loans rather than dividends. Where a loan is made to a shareholder in a smaller company, there is usually tax due from the company, which is 25% of the amount of the loan/overdrawn current account. This tax is repayable when the loan is repaid. Tax and NI under the benefit rules will also be due but loans to owner-managers may still prove to be a more attractive option than an outright dividend payment taxed at the new 42.5% rate. It is important to ensure that the loan is properly documented to avoid problems with HMRC attempting to class the loan as PAYE earnings.

### So what about dividends?

Over many years, the attraction of a company for many owner managers has been the possibility of avoiding large chunks of NI by paying dividends. So what is the effect of the new rules on the remuneration/dividend position in light of the above changes and a possible increase in the rate of corporation tax to 22% from 1 April 2010?

This is probably best illustrated by way of some examples.

**Example - small companies' rate of corporation tax and higher rate**

Chris is to receive a bonus of £60,000 after all taxes from his family company. He has a marginal income tax rate of 40% (32.5% if dividends) for 2010/11 and already has earnings above the employees' upper earnings limit for NIC purposes so that any bonus will be liable to employees' NICs at 1%. The company pays corporation tax at the small companies' rate of 22%.

| | Dividend | Bonus |
|---|---|---|
| **Chris** | **£** | **£** |
| Dividend/remuneration | 80,000 | 101,695 |
| Less: National Insurance (1%) | | 1,017 |
| Add: Tax credit (1/9) | 8,889 | |
| | 88,889 | 100,678 |
| Less: Income tax (@ 32.5% / 40%) | 28,889 | 40,678 |
| NET RECEIPT | £60,000 | £60,000 |
| | **Dividend** | **Bonus** |
| **Company** | **£** | **£** |
| Payment by company | 80,000 | 101,695 |
| Add: Employer's NIC (@ 12.8%) | | 13,017 |
| | | 114,712 |
| Less: Tax relief (@ 22%) | | 25,237 |
| COST TO COMPANY | £80,000 | £89,475 |

If the company pays a higher rate of corporation tax such as the full rate of 28%, additional tax relief will reduce the cost of the bonus. The extra relief however is still insufficient to make the bonus cheaper than the cost of a dividend. Similarly, where a company has profits charged at the marginal rate of 29.5%, because its profits exceed £300,000 but have not yet reached £1.5 million, the bonus cost is still fractionally more costly than the cost of a dividend.

**Example - small companies' rate of corporation tax and additional rate**

Chris is to receive a bonus of £60,000 after all taxes from his family company. He has a marginal income tax rate of 50% (42.5% if dividends) for 2010/11 and already has earnings above the employees' upper earnings limit for NIC purposes so that any bonus will be liable to employees' NICs at 1%. The company pays corporation tax at the small companies' rate of 22%.

| | Dividend | Bonus |
|---|---|---|
| **Chris** | **£** | **£** |
| Dividend/ remuneration | 93,913 | 122,449 |
| Less: National Insurance (1%) | | 1,224 |
| Add: Tax credit (1/9) | 10,435 | |
| | 104,348 | 121,225 |
| Less: Income tax (@ 42.5%/50%) | 44,348 | 61,225 |
| NET RECEIPT | £60,000 | £60,000 |
| | **Dividend** | **Bonus** |
| **Company** | **£** | **£** |
| Payment by company | 93,913 | 122,449 |
| Add: Employer's NIC (@ 12.8%) | | 15,673 |
| | | 138,122 |
| Less: Tax relief (@ 22%) | | 30,387 |
| COST TO COMPANY | £93,913 | £107,735 |

As previously, even if a company gets a higher tax saving on the bonus, because it pays a higher corporation tax rate, using current rates, the bonus remains more costly.

### Income splitting still works

Following HMRC's defeat in the Arctic Systems case, many owner-managed companies continue to pay dividends to the owner-manager's spouse.

However, HMRC announced that such arrangements were unacceptable and that they were going to introduce legislation to counter this so-called income shifting.

Currently, the government seem to have put these income shifting rules on to the back-burner which may allow a further element of planning by paying income to non working family members.

**What to do**

There are lots of things to think about in relation to these changes in the tax system. As always, we are here to help. Please do get in touch as soon as possible to discuss your options.

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