

Pensions: 40% tax relief not enough – Does 400% sound more tempting?

It is common knowledge that higher rate taxpayers can receive tax relief at 40% on pension contributions. Less commonly known is that it's possible to receive effective tax relief of well over 100%, and sometimes as high as 400%. Sound too good to be true? In the right circumstances this can be achieved with straightforward and uncontroversial planning.

This opportunity can arise when you make pension contributions in a year when you also make chargeable gains on life assurance bonds. Life assurance bonds, particularly with-profits bonds, have been extremely popular in the UK retail marketplace. The reduced popularity of with-profits and the proposed reduction in capital gains tax to 18% from April 2008 may mean that life assurance bonds will be seen as considerably less attractive when compared to alternative investment structures. However, the chargeable gain regime for life assurance taxation can throw up some interesting planning opportunities, particularly for existing bond holders looking to exit their investments.

Let us look at some examples:

Mr Darling was born on 1 January 1948 and invested £100,000 into an onshore investment bond on 1 January 1988. He has never made any withdrawals or further contributions into the bond. He encashed the bond for £250,000 on 1 January 2008 making a chargeable gain of £150,000.

Scenario 1: Mr Darling earns a salary of £75,000 for 2007/08, has no further income and makes no pension contributions. As he is a higher rate taxpayer, top slicing relief is not available and he will therefore suffer an income tax liability of £30,000 (£150,000 x 20%, with 20% tax assumed paid within the bond). However, suppose he made a personal pension contribution of £33,286.50 net of basic rate tax in 2007/2008.

Before payment of the pension premium		After payment of the pension premium	
Mr Darling's income	£75,000.00	M Darling's income	£75,000.00
Less personal allowance	£5,225.00	Less personal allowance	£5,225.00
Less pension premium	<u>£0.00</u>	Less gross pension premium	<u>£42,675.00</u>
	£69,775.00		£27,100.00
£2,230 taxed @ 10%	£223.00	£2,230 taxed @ 10%	£223.00
£27,545 taxed at 22%	£7,121.40	£24,870 taxed @ 22%	£5,471.40
<u>£35,175 taxed @ 40%</u>	<u>£14,070.00</u>	<u>£7,500 top sliced bond gain</u>	<u>£0.00</u>
£34,600.00	£21,414.40	£34,600.00	£5,694.40
Plus overall tax on bond gain	<u>£30,000.00</u>	Plus tax on total gain	<u>£0.00</u>
Total income tax liability	£51,414.40	Total income tax liability	£5,694.40

A net pension premium of £33,286.50 increases his basic rate tax band by the gross premium of £42,675 (£33,286.50/78%). The pension contribution leaves £7,500 of his basic rate band unused, which equals the top sliced gain of £7,500 (£150,000/20 years) on the bond.

The total income tax saving is £51,414.40 - £5,694.40 = £45,720 or **107%** of the gross pension premium of £42,675. So by paying **£33,286.50** into a pension, saves tax of **£45,720**.

Scenario 2: Utilising the same bond details but assuming Mr Darling earns a salary of only £35,000 for 2007/08. Again he has no further income. He will suffer an income tax liability of £10,700 on the bond gain. This is calculated as follows. The top-sliced bond gain for each year is £7,500 (£150,000/20). The remaining basic rate tax band is £4,825 leaving £2,675 to attract higher rate tax. Total tax due is 20 (years) x £2,675 x 20% = £10,700.

Before payment of the pension premium	
Mr Darling's income	£35,000.00
Less personal allowance	£5,225.00
Less pension premium	<u>£0.00</u>
	£29,775.00
£2,230 taxed @ 10%	£223.00
£27,545 taxed at 22%	£6,059.90
<u>£4,825 top sliced bond gain</u>	<u>£0.00</u>
£34,600.00	£6,282.90
Plus overall tax on bond gain	<u>£10,700.00</u>
Total income tax liability	£16,982.90

After payment of the pension premium	
M Darling's income	£35,000.00
Less personal allowance	£5,225.00
Less gross pension premium	<u>£2,675.00</u>
	£27,100.00
£2,230 taxed @ 10%	£223.00
£24,870 taxed @ 22%	£5,471.40
<u>£7,500 top sliced bond gain</u>	<u>£0.00</u>
£34,600.00	£5,694.40
Plus tax on total gain	<u>£0.00</u>
Total income tax liability	£5,694.40

A net pension premium of £2,086.50 increases his basic rate tax band by the gross premium of £2,675 (£2,086.50/78%). The pension contribution leaves £7,500 of his basic rate band unused which equals the top sliced gain of £7,500 (£150,000/20 years) on the bond. The total income tax saving is £16,982.90 - £5,694.40 = £11,288.50 or **422%** of the gross pension premium of £2,675. So by paying **£2,086.50** into a pension, saves tax of **£11,288.50**.

Conclusion

Life assurance taxation can be exceedingly complex. It is essential that bond holders receive advice on the best method to implement and exit their investment with the minimum tax charge. There are a number of planning opportunities open to bond holders not available to investments subject to CGT. Careful planning around encashments and utilising pension contributions can result in incredible tax savings, sometimes outweighing the amount of the pension contribution, i.e. over 100% tax relief. Most importantly this planning is uncontested and not an aggressive tax planning scheme.

You can read more about the intricacies of wealth management in our regular column, [The Intelligent Investor](#). For further information on this planning opportunity please contact Christian Ward at either office or via christian.ward@collinsward.com.

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