

Allowances and other figures mentioned in this Guide are based on the 2011/2012 tax year. References to married/spouse generally also include civil partnership.

## Introduction

This is a potential tax saving opportunity of which everyone age 65 or over – or perhaps fast approaching this age - should at least be aware. Thousands of retired people are paying an effective top rate of tax of 30% on part of their income. In most cases, they are completely unaware of it.

We are not talking about those who are sufficiently well off in retirement to be termed 'higher rate taxpayers', ie paying a top rate of tax of 40%. Rather, these are ordinary folk who, as a result perhaps of having been in a good occupational pension scheme, will have a total income in excess of £24,000.

The reason for this odd, but punitive, effective rate of tax, is that the person concerned has lost part, or all, of something that they may not have realised they had - their age allowance.

## If you are age 65 or over

If you are age 65 or over you might be enjoying an enhanced personal allowance, known as the 'age allowance'. This is £9,940 (although if you are age 75 or over, it is £10,090). This is a noticeable increase on the personal allowance of £7,475 that everyone enjoys.

This means that if you are entitled to the full age allowance and you are a basic rate tax payer (currently 20%), you could be saving an additional £493 in tax, ie 20% of (9,940 – 7,475).

To obtain your age allowance for a whole tax year you simply have to reach the age of 65 (or 75) at some time during that tax year.

Just to complete the picture, age allowance is also given where you were alive on the first day of the tax year and would have achieved the age of 65 (or 75) within the tax year, had you not died!

## If you are age 75 or over

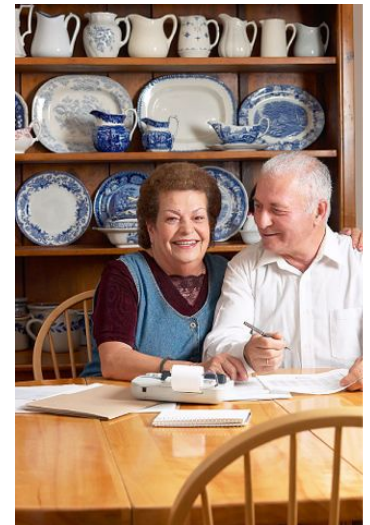
As we have already seen, if you are age 75 or over you might be enjoying an even higher level of age allowance.

For you, enjoyment of the full age allowance could enable you to save an additional £523 in tax, ie 20% of (10,090 – 7,475).

## If you are married

If either you or your spouse were born before 6th April 1935, there is a further age-related allowance, the married couple's allowance.

This is an additional £729.50 (the actual married couple's allowance is £7,295 but as only 10% is used to reduce your tax we have taken the 10% figure here).



If you were born after 5th April 1935, you can no longer make a new claim for the married couple's allowance, whatever age you reach. However, if you were born before 6th April 1935 and you subsequently marry, you will still be able to claim the allowance.

This might seem a compelling financial argument for many older single pensioners to get together!

## Age Allowance is often lost

As mentioned earlier, the full amount of the enhancement for age allowance is only available where your total income for the tax year is below £24,000.

Your age allowance is then reduced by £1 for every £2 by which your total income exceeds £24,000, until it falls back to the standard personal allowance.

Such a loss of age allowance is very bad news. Within this band, every £2 of income can cost 60p in tax (ie 40p on the £2 itself, plus 20p on the £1 of allowances withdrawn). This is an effective personal tax rate of 30%.

Example of single person age 66		
(a)	Total income	28,000
(b)	Excess over £24,000	4,000
(c)	Full age allowance	9,940
(d)	Excess (b) divided by 2	2,000
(e)	Reduced age allowance (9,940 – 2,000)	7,940
(f)	Taxable income (a) – (e)	20,060
(g)	<b>Tax payable at 20% of (f)</b>	<b>4,012</b>

The investor in the previous example will not only pay 20% basic rate tax on the excess income of £4,000 (ie £800) but as they have also lost a tax free allowance of £2,000 this will cost them a further 20% of £2,000 (ie £400). The effective tax charge on the excess income of £4,000 is, therefore, £1,200 (ie £800 plus £400) which is 29.91% (ie £1,200 / £4,012).

If this investor's income were to reach £28,930 the age allowance would be reduced to £7,475 (ie the same as the standard personal allowance) and there would be no further reduction in their personal allowance, however high their income.

## Married couple's allowance can also be lost

If you are entitled to the married couple's allowance you will also find that this can be lost in a similar way to the basic age allowance.

You will find that your personal age allowance is reduced first, until it falls back to the standard personal allowance. Then your married couple's allowance is reduced until it reaches a minimum of, currently, £280 (the actual basic married couple's allowance is £2,800, but as only 10% is used to reduce your tax we have taken the 10% figure here).

Example of married person born in 1934		
(a)	Total income	30,000
(b)	Excess over £24,000	6,000
(c)	Full age allowance	9,940
(d)	Excess (b) divided by 2	3,000
(e)	Reduced age allowance (c) – (d)	6,940
(f)	However, this cannot be below the standard personal allowance	7,475
(g)	Unused excess (f) – (e)	535
(h)	Full Married Couple's Allowance (MCA)	7,295
(i)	Reduced MCA (h) – (g)	6,760
(j)	Taxable income (a) – (f)	22,525
(k)	Tax payable at 20% of (j)	4,505
	<b>Less reduced MCA (k) – 10% of (i)</b>	<b>3,829</b>

This investor will not only pay 20% basic rate tax on the excess income of £6,000 (ie £1,200) but as they have also lost a tax free allowance of £2,465 (ie 9,940 – 7,475) this will cost them a further 20% of £2,465 (ie £493). In addition they have lost a further £53.50 (ie 729.50 - 676) by losing some of their married couples' allowance. The effective tax charge in this case is, therefore, £1,941.50 (ie £1,200 plus £493 plus £53.50) which is 29.11% (ie £1,746.50 / £6,000).

The married couple's allowance is normally able to be claimed by the husband, except that for couples who married on or after 5th December 2005, it can be claimed by the person with the highest income.

You can decide to share the minimum married couple's allowance between you or, if you both agree, you can elect to transfer the whole of the minimum married couple's allowance to your spouse. You will need to do this before the start of the tax year.

There is a tax planning opportunity here if one of you has a very high income and you are losing all of your age allowance together with the married couple's allowance, whilst the other spouse has a significantly lower income.

## A word to those under 65



The age allowance situation shows how important it is to start planning for your later years in a more thoughtful way than just putting as much as you can afford into a pension plan. For example:

- You and your spouse, or partner, should try to equalise your pension funding as much as possible. If one of you is a member of a good occupational pension scheme, any additional pension contributions may be better directed into a personal pension plan for the other spouse, rather than enhancing the occupational pension scheme benefits even further.
- You will naturally expect to take maximum tax-free cash (ie a pension commencement lump sum) from your pension plan(s) when you come to take the benefits. This can then be invested where the income will not be taken into account for the age allowance threshold.

One note of warning here is that you must take professional advice when taking tax free cash, because it is not always in your interests to do so, especially where, for example, the pension has a guaranteed annuity rate or the cash commutation terms under the occupational pension scheme are not overly attractive.

- If you require the maximum 'pension' income, it can still make sense to take the tax free cash and then pass it to your spouse or partner who could use the capital to obtain a purchased life annuity, or other income, in their name.

- If you have already built up substantial pension benefits, you might wish to consider redirecting some of your future contributions into non-pension investments such as ISAs or a unit trust portfolio.
- For the more adventurous, you could consider investing in Venture Capital Trusts (VCTs) to still obtain a measure of tax relief on your investment.

## The right kind of investments

The good news if you find yourself caught in the 'age allowance trap' is that there are a number of straightforward tax planning opportunities that could be used to improve your situation.

The most important thing that you can do is to review your current investments, to see if they are 'fit for purpose', ie to give you the most benefit in this situation.

Income from ISAs and VCTs is especially valuable, as it is not liable to tax in your hands and more importantly, for our purposes, does not count as income for the purposes of the age allowance threshold.

## 'Income' from Life Assurance Bonds

There are many types of investments that have the word 'bond' in their name and not all of them, by any means, are life assurance bonds.

Such life assurance bonds will either have a generic sounding name, such as Capital Investment Bond, reflecting the fact that you can invest in a range of different underlying investments, or their name may indicate a specific underlying investment fund such as With Profit Bond, Distribution Bond, or Property Bond.

All of these benefit from the fact that any liability to tax on the first 5% per annum of regular withdrawals of 'income' is deferred until the bond is encashed (or until the total amount withdrawn exceeds 100% of the original investment). The first 5% of this 'income' is not taken into account for the purposes of the age allowance threshold.

Furthermore, if the 5% allowance is not taken in a particular year, it can be accumulated so that a larger sum can be extracted in a later year without affecting the age allowance.

Although there are many other factors to consider - not least the risk to capital - in theory, just moving capital from a deposit account to a life assurance bond could take you out of the age allowance trap, thus saving you tax at an effective rate of 30%. There will be tax, typically around 15% to 20%, deducted from the funds held by the life assurance bond but we can assume that the person in this example would have been paying 20% tax on their deposit account anyway.

Example of single person age 66		
	Total State and private pensions	20,500
	Gross income (assumed at 2.5%) from £300,000 held in various bank and building society accounts	7,500
(a)	Total income	28,000
(b)	Excess over £24,000	4,000
(c)	Full age allowance	9,940
(d)	Excess (b) divided by 2	2,000
(e)	Reduced age allowance (9,940 - 2,000)	7,940
(f)	Taxable income (a) – (e)	20,060
(g)	<b>Tax payable at 20% of (f)</b>	<b>4,012</b>

This is simply a repeat of our first example but breaking down the income into pension and investment income.

If this person were to move £200,000 from their bank and building society accounts into a life assurance bond (which could have a range of funds to suit the investor's attitude to risk), their tax situation would be improved without affecting their overall income position.

Example of single person age 66		
	Total State and private pensions	20,500
	Gross income (assumed at 2.5%) from £100,000 held in various bank and building society accounts	2,500
	Withdrawals of 'income' at 2.5% of £200,000 invested in a life assurance bond (this is not taken into account for age allowance purposes)	5,000
(a)	Total income	28,000
(b)	Total income for age allowance purposes	23,000
(c)	Excess over £24,000	Nil
(d)	Full age allowance	9,940
(e)	Taxable income (a) – (d)	18,060
(f)	<b>Tax payable at 20% of (e)</b>	<b>3,612</b>

Just by transferring part of their capital into a different type of investment, this investor saves £400 in tax.

In current economic conditions it would not usually be deemed prudent for an investor to take withdrawals as high as 5% from any investment, including a life assurance bond. With the future in mind, however, if regular withdrawals in excess of 5% are taken from a life assurance bond, only the excess over 5% counts towards income for age allowance purposes.

We have used life assurance bonds here as an example because the 'income' is predictable and controllable and there are no limits as to how much can be transferred into such products. However, for some people, taking regular fixed withdrawals from a low yielding unit trust portfolio may be more appropriate. Money could also be moved into ISAs, within limits.

## 'Income' from High Income Bonds

High Income Bonds are a form of 'structured product', and as a number of these have resulted in large capital losses for investors they are not as popular as they were some years ago.

Many investors still hold such products in their portfolios, however, so it is necessary to deal with their impact on age allowance.

A High Income Bond usually offers a high fixed rate of income over a fixed term but the capital return is dependent on the performance of one or more stockmarket indices.

The treatment of the income for age allowance purposes is straightforward once you are clear how the bond has been set up.

Some High Income Bonds have been set up as ISAs and this income will be ignored when working out your total income for age allowance purposes.

So this is the best way to set up a High Income Bond but, of course, you are limited to the amount that can be invested in an ISA.

Other High Income Bonds are set up as life assurance bonds. With these, as we have seen, the first 5% of annual income does not count towards the age allowance threshold, although the excess does.

It is important to be aware, therefore, that an attempt to obtain a higher net income by investing in a High Income Bond may not always be successful, because all or part of that additional income may produce a reduction in your age allowance and the 30% effective rate of tax which this entails.

Such bonds often target a high capital return instead of a high income. The fact that the term of such bonds is usually fixed, however, allows no opportunity to avoid a potential loss of age allowance in the year that the bond matures (see next heading).

## Encashment of Life Assurance Bonds

Whilst life assurance bonds can be used beneficially to maintain your age allowance, there is a potential problem in the year in which a life assurance bond is fully encashed.

This is because the whole of the gain is included in your income for age allowance purposes in the year of encashment. Although in practice, a procedure referred to as 'top-slicing' can reduce, or remove, any liability to higher rate tax on the gain from a life assurance bond, top-slicing cannot help to reduce the gain for age allowance purposes.

The whole of your age allowance could easily be lost in the year in which you encash a life assurance bond, since the amount of gain plus other income frequently exceeds the age allowance threshold.

It is possible, however, to do some tax planning to avoid this problem as follows:

- Where you are not yet 65 you should review your life assurance bonds before the tax year in which you will reach 65. If other investments may be just as suitable you should consider surrendering your life assurance bond(s) before you start to receive your age allowance.

In this respect please see our Guide: *Review Your Life Assurance Bonds*.

- You could assign the bond to your spouse if he or she is able to encash the bond without exceeding their own age allowance threshold, or indeed if they will already have lost their age allowance in a particular tax year. There are no other tax implications as a result of such an assignment.
- Particularly if the bond is segmented, you could spread the encashment over a number of tax years.
- You could assign segments of your bond to other family members (but not to minors) to encash; for example, to older grandchildren to fund their university education.

The important point if you already own one or more life assurance bonds, is to try and plan ahead if you want to make large capital withdrawals from them.

You should also discuss any such large withdrawals with an independent financial adviser before it is made, as there can be different tax implications depending on how the withdrawal is actually made.

## The use of Pension Contributions

Pensions are fairly inflexible as far as age allowance is concerned, as there is little that you can do to reduce your pension income.

If you are married you could divorce your spouse and, under current legislation, he or she would be able to claim a share of your pension, thus possibly placing you both below the age allowance income threshold. We hope that you would agree, however, that this is too drastic a measure simply to save some tax!

However, there is a tax planning opportunity that you may wish to consider. Pension contributions are set off in full against your income for age allowance purposes.

Furthermore, you do not need to be earning an income to contribute to a personal pension plan.

All UK residents can contribute up to £3,600 gross (ie £2,880 net) a year to a pension plan without any proof of relevant earnings.

Example of single person age 66	
(a) Total income	28,000
(b) Contribution of £3,600 to pension	3,600
(c) Revised total income for age allowance purposes (a) – (b)	24,400
(d) Excess over £24,000	400
(e) Full age allowance	9,940
(f) Excess (d) divided by 2	200
(g) Reduced age allowance (9,940 - 200)	9,740
(h) Taxable income (a) – (g)	18,260
(i) <b>Tax payable at 20% of (h)</b>	<b>3,652</b>

This investor has not only made a tax saving of £360 (ie over the £4,012 in a previous table), but will also receive £720 (ie 20%) tax relief at source added to their pension fund.

### Those Earning £100,000 Plus

Although not concerned with age allowance, it is worth noting that a similar ‘tax trap’ occurs once a person’s income exceeds £100,000 pa, only in this case the personal allowance itself is lost.

There is a £1 loss of personal allowance for every £2 earned over £100,000. Therefore once your income reaches £114,950 your personal allowance is completely removed.

Example of any adult person	
(a) Total income	114,950
(b) Excess over £100,000	14,950
(c) Full personal allowance	7,475
(d) Excess (b) divided by 2	7,475
(e) Reduced personal allowance (7,475 – 7,475)	0
(f) Taxable income (a) – (e)	114,950
(i) Tax payable at 20% of £35,000	7,000
Tax payable at 40% of [(f) - £35,000]	31,980
<b>Total tax payable</b>	<b>38,980</b>

This investor will not only pay 40% higher rate tax on the excess income of £14,950 (ie £5,980) but as they have also lost a tax free allowance of £7,475 this will cost them a further 40% of £7,475 (ie £2,990). The effective tax charge on the excess income of £14,950 is, therefore, £8,970 (ie £5,980 plus £2,990) which is 60% (ie £8,970 / £14,950).

Pension contributions can again be useful in such a situation. If someone earning £114,950 were to contribute £114,950 to a pension plan the real cost of that pension contribution would be greatly reduced.

Example of any adult person	
(a) Total income	114,950
(b) Contribution of £14,950 to pension	14,950
(c) Revised total income for personal allowance purposes (a) – (b)	100,000
(d) Excess over £100,000	0
(e) Full personal allowance	7,475
(f) Excess (b) divided by 2	0
(g) Reduced personal allowance (7,475 – 0)	7,475
(h) Taxable income (a) – (g)	107,475
(i) Tax payable at 20% of £35,000	7,000
Tax payable at 40% of [(h) - £35,000]	28,990
<b>Total tax payable</b>	<b>35,990</b>

This investor has not only made a tax saving of £2,990 (ie over the £38,980 in the previous table), but will also receive £5,980 (ie 40%) tax relief on their pension contribution. The pension contribution of £14,950 has therefore really cost them £5,980 (ie £14,950 - £2,990 - £5,980).

In the last example, ignoring investment gains on the pension contribution, the investor could, under current legislation, take 25% of the pension fund, or £3,737, as tax free cash at any time after age 55. The real cost of purchasing the remaining pension fund of £11,212 will have been just £2,242 (ie £11,212 – £5,980 - £2,990).

### A final thought

The age allowance threshold of £24,000 has been set so that only ‘those of limited means’ in retirement might enjoy higher tax allowances. A couple could therefore have a joint retirement income of well over £40,000 pa and still be considered as those of limited means.

At the same time, the average pension fund that we see at retirement is still under £100,000.

Given present annuity rates, a fund of at least £500,000 may be required by a retiring couple, both aged 65, to get anywhere near £40,000 a year income overall, including joint State pensions of £12,000 (for illustration purposes only).

The figure of £500,000 assumes that a level (ie non-increasing) annuity (ie a guaranteed income for life) to provide £28,000 pa will be purchased.

Once we allow for the £28,000 pa to be inflation-linked (ie linked to the Retail Prices Index) a fund of at least £850,000 is required.

Even that is not a true requirement because most people will want to avail themselves of a tax free cash sum from their pension fund. In simple terms this couple will require a pension fund of around £1m, over ten times the average pension fund we are seeing at present.

Figures based on the best annuity rates available from *The Exchange* 05/01/2012

For the increasing numbers of people who do not have access to final salary style pension benefits, income in later life needs to take on a much greater priority - and at a much earlier age.

For those who have not yet fully retired, we will be very pleased to produce a simple report for you, totalling all of your existing pension funds and projecting the pension benefits at your likely retirement date.

Please note that this information does not constitute personal advice and should not be treated as a substitute for specific advice based on your circumstances.

Any information given in this Guide relating to income tax legislation is based on our understanding of legislation and practice in force at the date of this Guide. Whilst we believe our interpretation of current law and practice to be correct in these areas, we cannot be responsible for the effects of any future legislation or any change in interpretation or treatment.

In particular you are warned that levels of tax and tax reliefs and also State Benefits that may have been referred to, are subject to alteration and, in any case, the value of such reliefs and benefits may depend on an individual's circumstances.

### For personal advice

If you would like to receive advice on your investment planning or pension planning please ask your usual Arch adviser or contact us via one of the following:

Tel: **0845 3700 661**  
or **01483 204600** (if local)  
Email: **enquiries@arch-fp.co.uk**  
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