nb: Flash Note – New Pensions Legislation

business owners to profit from pension flexibility...

Business owners looking to extract surplus profits from their business will be looking forward to April's new pension income flexibility. Not only will pension funding remain the most tax efficient way to extract profits, but those funds will also become far more accessible than ever before.

Allowable contributions have the double benefit of reducing the profits subject to corporation tax, without incurring an employer National Insurance liability. Extraction by salary or bonus will reduce profits before tax, but will not side step NI.

The only previous downside for business owners was that pension funds were not as readily accessible as cash. But all that will change from April if the owner of the business is over age 55. This could lead to business owners seeking advice on how to maximise their contributions.

how much can be paid...?

Potentially if someone has not paid anything into their pension for some time they can pay up to £230,000 now. This would be done in two stages. First, by using carry-forward from the 3 previous tax years. This amounts to £150,000 using allowances from 2013/14, 2012/13 & 2011/12. Plus, in order to carry-forward they would also have to pay the maximum £40,000 for the current year. Potentially they may also be able to pay a further £40,000 towards next year's allowance now if their current input period ends in the 2015/16 tax year.

Unlike paying pension contributions personally, company contributions are not limited by the business owner's earned income. Instead, the company just has to be able demonstrate that the contributions were ‘wholly and exclusively for the purpose of trade'. However, the company would typically need to have enough profits in the accounting year to get the full benefit of corporation tax relief.

the financial dangers of hoarding cash...

There may also be a spin off benefit of paying surplus profits to a pension instead of capitalising it:

1. Inheritance tax
Shares in unquoted trading companies normally attract IHT business property relief (BPR). But cash built up in the company bank account or investments held within the company could be regarded as an ‘excepted asset' and not qualify for BPR. To qualify for relief; cash has to have been used in the business in the past two years or earmarked for a specific future business purpose. Clients should always obtain professional advice to get clarity on their particular situation.

With many companies still stockpiling cash following the credit crunch, some business owners could be unwittingly storing up an IHT charge. Amounts over and above their company's usual working capital could be included within their estate.

Paying into their pension could help ease this. There is typically no IHT payable on pension death benefits provided the contributions weren't made when they were in ill health. Extracting the cash from the business in the form of a pension contribution could result in an immediate reduction in the business owner's estate.

2. Capital Gains Tax
Holding excess cash in the business could cause similar issues when shares in the company are sold. Entrepreneurs' relief is valuable to business owners as it can reduce the rate of CGT payable on the disposal of qualifying shareholdings to just 10%. To qualify the shares must be in a trading a company. A trading company for this purpose is one which does not include substantial non-trading activities.

While cash reserves are not looked at in isolation, holding substantial cash and other investments could contribute to a company losing its 'trading' status. And unlike BPR, entrepreneurs relief is all or nothing. If cash and investments trigger a loss in relief it affects the full value of the business disposed of; not just the non-trading assets.

CGT will not be an issue if they intend to pass their shares on death to other family members. But it could have huge implications for business owners approaching retirement and planning to sell their business as part of their exit strategy. Extracting surplus cash through pension planning to ensure entrepreneurs' relief is secured on sale of the business will be an important consideration.

the cost of delay...

Each year clients delay, the maximum amount they can pay using carry-forward will diminish. The annual allowance cut from £50,000 to £40,000 in 2014/15 will reduce the amount that can be carried forward by £10,000 for each of the next 3 years. By 2017/18 the maximum carry-forward will have dropped from £190k to £160k.

What difference could this make to your retirement pot? Well, if planned retirement was in 10 years, a net annual growth rate of 4% after charges on £190k would provide a pot of over £281K.

By contrast, waiting three years and investing £160k, the accumulated pot would be £210k - almost £71k less.

time to act...

With the main rate of corporation tax set to fall by 1% from 1 April it makes sense to bring forward pension funding to maximise relief. Paying contributions in the current accounting period will see a reduction in the profits chargeable at a higher rate of corporation tax.

All in all, there are many compelling reasons to use pensions to extract profits which aren't required for future business use. And the longer they leave it the greater the danger of missing out on valuable reliefs.

The value of tax reliefs depends on your individual circumstances. Tax laws can change. The Financial Conduct Authority does not regulate tax and trust advice. The value of your investment can go down as well as up and you may not get back the full amount you invested. Past performance is not a reliable indicator of future performance. Investing in shares should be regarded as a long-term investment and should fit in with your overall attitude to risk and financial circumstances.