



EDITORIAL: COLIN CLARK

CARRY FORWARD OPTIONS FOR THE SELF-EMPLOYED

- Q. How do the new carry forward rules, effective from 6 April 2011, help the self-employed?
- A. A combination of fluctuating earnings, cash flow issues and seeking the highest rates of marginal tax relief, means spreading carry forward pension contributions over up to three years could be better than a one-off payment in a single tax year.

Self-employed people often don't know exactly what their earnings will be until late in the tax year and sometimes not until after it has ended. This may depend on when their particular accounting period ends. For example, for those ending on 30 April (near the start of the tax year) it should be possible to get a reasonably accurate earnings figure for that tax year. For others it may not be so straightforward.

On the face of it, anyone in this position looking to pay pension contributions of around $100\,\%$ of relevant UK earnings has a dilemma:

- pay 100 % based on estimated earnings and risk overpayment or,
- pay less, and miss out on tax relief and/or investment opportunities.

In theory having a reduced annual allowance limits the number of people affected by this to those with earnings under £50,000. Higher earners won't want to pay in more than £50,000 anyway – unless they're using carry forward!

However, although carry forward looks back three tax years, for tax relief purposes the contribution is based on the current year's earnings.

So the maximum tax relievable pension contribution is still $100\,\%$ of relevant UK earnings in the current tax year, even if carry forward is being used to pay more than the annual allowance of £50,000.

Therefore carry forward does not solve the issues around uncertain earnings. Unlike the old pre A-Day carry-back/carry-forward rules, much favoured by the self-employed, it does not allow tax relief to be claimed based on a previous year's earnings.

But carry forward still has its uses. It doesn't all have to be used in one go. And sometimes delaying payment of some of the carry forward pension contribution could lead to a more favourable outcome.

Consider the example of Jim. He has carry forward headroom of a total of £60,000. This is split as follows:

Tax year	Pension input amount (£)	Unused annual allowance (£)		
2008/2009	40,000	10,000		
2009/2010	20,000	30,000		
2010/2011	30,000	20,000		

In tax year 2011/2012, Jim hopes his taxable earnings will be £120,000 – the same as he received in 2010/2011. However Jim is concerned that his income can fluctuate considerably depending on availability of work and duration of contracts. He thinks the spread of income may be around 20 % above or below a median of £100,000. The next table illustrates the tax relief position in both monetary and percentage terms for a range of possible earnings/contribution scenarios in tax year 2011/2012.

	Projected earnings 2011/2012 (£)						
	80,000		100,000		120,000		
Pension Contribution (£)	0	70,000	0	70,000	0	70,000	110,000
Personal Allowance (£)	7,475	7,475	7,475	7,475	0	7,475	7,475
*Tax liability (£)	22,010	505	30,010	4,505	41,000	10,010	505
*Tax Relief (£)	0	21,505	0	25,505	0	30,990	40,495
Marginal rate of tax relief (%)	0	30.7	0	36.4	0	44.3	36.8

^{*}For more information about the timing of tax payments and reliefs for the self-employed please refer to Appendix A.

Jim could make a pension contribution of £110,000 (£50,000 Annual Allowance plus £60,000 carry forward). The marginal rate of relief will be 36.8% (£40,495) which he'll enjoy the benefit of by 31 January 2013. January 2013 and July 2013 payments on account for tax year 2012/2013 may also be lower. But, assuming the same or higher level of earnings is maintained, the balancing payment in January 2014 will probably be higher as pension contributions will be limited to no more than the £50,000 annual allowance and the payments on account are likely to increase again too.

If Jim pays in £110,000 and earnings are less than this in 2011/2012, he will have over-contributed. The pension provider would probably refund the excess after returning over-paid tax relief to HMRC and Jim would lose out on investment return. He may even receive back less than he paid in.

Alternatively, Jim could make pension contributions of £70,000 per annum for three years using £20,000 carry forward each year.

Assuming the same or higher level of earnings, and the same tax bands/reliefs, the effective overall marginal rate of tax relief increases by 7.5 % to 44.3 % (£30,990).

Steadier pension contributions over a three year time-span mean payments of tax on account in January and July, plus the following January's balancing payment, will also be more consistent, leading to easier budgeting.

We can also see that, if earnings slip back to £100,000, a £70,000 pension contribution delivers a similar marginal rate of tax relief as a £110,000 contribution when earnings are £120,000.

And don't forget that, if earnings exceed £100,000, a pension contribution means Jim also 'regains' his full personal allowance of £7,475, giving up to 20 % extra relief on £14,950.

But what if earnings reduce to £80,000 in Jim's worst-case scenario?

This will still be enough to cover the contribution so a refund will not be required.

Of course the effective marginal rate of relief is lower but still represents good value at more than 30 %. And it may be possible to reduce contributions to get a higher marginal rate. But if contributions reduced to less than £60,000 this would result in 'wasting' the £10,000 carry forward opportunity from three tax years previously.

Finally, although I've used the example of Jim who's self-employed, the same rationale could also be applied to an employed person.

SUMMARY

In the race to make the most of your clients' carry forward opportunities, consider aiming for the best outcome in terms of maximum tax relief as well as in terms of maximum pension contributions.

- Tax relief on pension contributions is part of the return your clients expect on their pension investment.
- Jim found that spreading the carry forward pension contribution over three years could give him an extra 7.5 % return virtually risk-free in the shape of extra tax relief.
- At the same time it reduces the risk of over-payment and any resulting lost value.

Please note: This may be partly offset by the difference between immediate tax-efficient investment in a pension compared to a delay of up to two years in investing the full amount. In addition there is the chance that future legislative changes to pensions tax relief might inhibit later payments. However we think the Government is unlikely to want to disturb the £50,000 annual allowance and carry forward rules again so soon after introducing them.

APPENDIX A

Personal pension contributions – timing of tax relief for the self employed

The self-employed meet their tax liability for any given tax year via two payments on account. These are due 31 January in the tax year and 31 July following the end of the tax year, with a final balancing payment (if any) due 31 January following the end of the tax year.

Contributions paid to all personal pension and stakeholder plans are paid net of basic rate tax under the relief at source method.

Making a pension contribution reduces that year's tax and also has the effect of reducing the following year's payments on account.

Where basic rate tax relief is granted, higher and/or additional rate reliefs are not given until the balancing payment, due on the following 31 January.

Alternatively earlier payments on account could be reduced where the liability for the current tax year would be lower than for the previous tax year. Individuals can use HMRC Form SA303 for this purpose. This means they may be able to feel the benefit of the tax relief much sooner.

However, the following year's balancing payment may be higher to compensate, particularly if pension contributions are not maintained.

Let's see how this works using a simple example.

We start by assuming that the tax liability in 2009/2010 was £20,000, giving rise to two payments on account for 2010/2011 of £10,000 each. Then assuming no pension contribution is made, subsequent tax liabilities are:

	2010/11 tax due £22,000		2011/12 tax 2012/13 tax due £25,000 due £30,000				
	31.01.11	31.07.11	31.01.12	31.07.12	31.01.13	31.07.13	31.01.14
2010/11	£10,000	£10,000	£2,000				
2011/12			£11,000*	£11,000*	£3,000		
2012/13					£12,500	£12,500	£5,000

Alternatively a pension contribution of £10,000 gross (£8,000 net) is made on 1 August 2011. Assuming $40\,\%$ relief applies, and no change to 2011/2012's payments on account, the figures change as follows:

	2010/11 tax due £22,000		2011/12 tax due £23,000		2012/13 tax due** £30,000		
	31.01.11	31.07.11	31.01.12	31.07.12	31.01.13	31.07.13	31.01.14
2010/11	£10,000	£10,000	£2,000				
2011/12			£11,000*	£11,000*	£1,000		
2012/13					£11,500	£11,500	£7,000**

^{*}Half the 2010/11 liability, £11,000 each payment

Making a pension contribution reduces that year's tax and also has the effect of reducing the following year's payments on account.

^{**}Assumes no pension contribution made in 2012/2013 tax year.