Mattioli Woods plc

30% TAX RELIEF (TWICE!), TAX-FREE INCOME AND NO CGT – REALLY?

For most investors, pensions and ISAs are their first ports of call for saving tax efficiently writes Mattioli Woods' Consultant, Jack Silk.

For most investors, pensions and ISAs are their first ports of call for saving tax efficiently, but over the years rule changes have been made to reduce these allowances, namely the implementation of the lifetime allowance (LTA) and its subsequent reductions, and the tapered annual allowance, to name just a couple. So how else can our clients save tax efficiently? I thought the true-life example below might be of interest.

James was in his 50s, married to Sally, with his children no longer dependent (apparently this does happen!). Being a well-paid employee after many years of hard work, he was in a position where he had spare cash to invest to help with his retirement, intended for around age 60. With the pension out of the equation due to his high earnings and ISAs already accounted for, we considered venture capital trusts (VCTs).

VCT initial investments receive 30% income tax relief, as well as tax-free dividend income and are free from any capital gains tax liability upon sale. So why are they not used more?

Although VCTs are higher risk due to investing in smaller companies, we discussed James's attitude to risk and capacity for loss in extreme detail at a time when face-to-face meetings were still the norm. Following our discussion, we decided to reduce the risk of his fully funded pension scheme, albeit slightly, as very strong growth would create further LTA charges that we wanted to avoid. This meant we could take a higher level of risk elsewhere, so that the overall position remained in line with his risk profile.

In addition, rather than a 'one-off' transaction, we started to use VCTs on an annual basis, with smaller amounts, but more frequently. This meant we could increase diversification across several VCT investments, with the aim of reducing risk. Over a five-year period of investing £10,000 per annum, we had saved James £15,000 in income tax and built a VCT portfolio worth £50,000.

VCTs need to be held for five years to retain the income tax relief. Therefore, at the five-year point VCTs can be sold free of CGT and without any income tax repercussions. As James's ISA and pension scheme were accessible, having these investments tied up for five years was not an issue.

At the five-year point we had the following options:

- Sell the VCTs and retain the cash
- Sell the VCTs and invest elsewhere (maybe use proceeds to top up ISAs?)
- Retain the VCTs as a tax-efficient income-producing investment throughout retirement
- Sell the existing VCTs and buy more VCTs, but still retain the tax-efficient income through retirement

At year 5 following his initial investment, James was still working and was happy to continue saving for another couple of years. He continued to maximise his ISA allowance, which took up most of his spare cash, but he still wanted to reduce his income tax liabilities.

Therefore, we proceeded with the final option of selling his existing VCTs and using the proceeds to buy more in a separately managed VCT, creating the second tranche of 30% tax relief, all while he continued to receive tax-free income and had no CGT exposure.

Into retirement, it seems likely that James will continue this strategy, obtaining tax relief on the income created from his pension scheme through his existing VCT portfolio. Dependent on how well the pension scheme eventually performs might mean there is more to do with VCTs to help reduce the burden of tax that could become due if he breaches the LTA in the future.

The above is an example and should not be construed as advice as investment decisions should be taken with advice, with consideration of individual circumstances so please get in touch if you would like to know more.

The information contained in this article is correct as of the 2020/21 tax year.