financial focus

Spring 2009

rosan helmsley

Confidence – the missing ingredient

2008 will be a year that many investors will want to forget. As well as being a sobering experience, particularly for those thinking our largest banks were wise investments, it has been a time when the two primary investment emotions – fear and greed – have been brought sharply into focus.

Kathryn Highett

Already in 2009 we have had confirmation that the UK is in recession, unforeseen by our current government, who have consistently pontificated that the days of boom and bust are behind us. How long a UK contraction in growth will last is open to debate, but one thing is certain: a renewed focus on both our national and personal debts and financial balance sheets is imperative.

Confidence in investment markets can be lost very quickly, and nearly always takes time to rebuild. In the first half of 2009, markets are likely to continue to be influenced by current news rather than anything further afield. However, we should not forget that markets and economic fundamentals are rarely aligned and a recovery in the former can (and normally does) occur well before any recovery in the latter. Like using a good barometer, it is important to look at today's reading, but also to tap the glass and see what lies ahead. The current economic outlook looks grim, but the valuations of various asset classes are becoming increasingly more attractive, particularly as returns from cash collapse: the income yield from the UK equity market at well over 4% looks appealing, whilst yields of more than 7% on investment grade corporate bonds look enticing too.

There are other reasons for a return of confidence and optimism. With the swearing in last week of Barack Obama as President of the United States, the world's largest economy has a leader with a very fresh outlook on politics and business. Obama is planning a stimulus to the US economy of circa $1 trillion and the US does have a habit of delivering the world out of protracted recession.

For our own part, it is pleasing to report that Rosan Helmsley increased its own revenue by over 20% last year, a reflection of the fact that the demand for our guidance and advice through these difficult periods is on the increase.

I also want to take this opportunity to announce the appointment of Kathryn Highett as a director of the company with effect January 1st. Kathryn is responsible for the administration and operational functions of the business as well as running our SIPP department. Kathryn has worked with me for 10 years and has been instrumental in building our successful IFA business. I'm sure you will join me in wishing her every success in her role.

Please contact us if you require further information on any of the articles in this newsletter.

Rob Sandwith | Chief Executive

In this issue: Make a move on interest rates • Think ahead on income tax planning • Another round on pensions • Income shifting legislation delayed

This newsletter is for general information only and is not intended to be advice to any specific person. You are recommended to seek competent professional advice before taking or refraining from taking any action on the basis of the contents of this publication. The newsletter represents our understanding of law and HM Revenue & Customs practice as at January 2009.

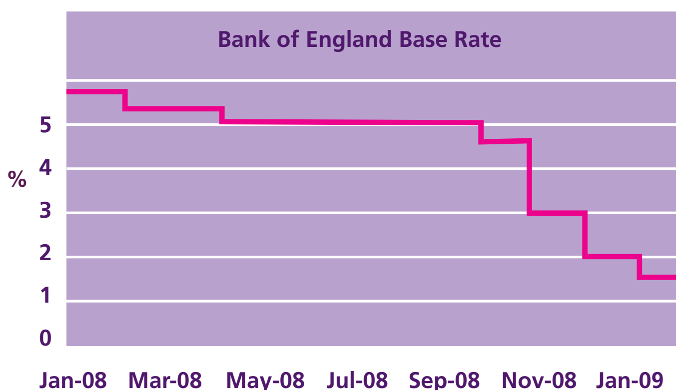
Make a move on interest rates

There are several ways to obtain income yields well above the 1.5% gross of base rate...

In January 2008, the Bank of England base rate was 5.5%. By 8 January 2009, it was just 1.5%, the lowest level since the Bank was created in 1694.[1] It is quite possible that the rate will fall further – the US already has virtually 0% rates.

The government has made clear that it wants the Bank of England rate reductions to feed through to lending rates, a stance that has left banking institutions with little alternative but to slash savers' rates in parallel. The dramatic drop in base rates has therefore been good news if you have a variable rate mortgage, but is much less welcome if you rely on bank or building society interest to supplement your income.

If your deposit interest rate matches the base rate – and many variable rate accounts pay less – your monthly interest income for February 2009 will be little more than a quarter of January 2008's sum. This rapid change underlines a fact that has been forgotten in recent years: a variable rate deposit is a secure home for 'rainy day' money rather than a reliable source of long-term income.



If your priority is income rather than capital security and instant access, the fall in short-term interest rates does not have to lead to a corresponding drop in your income. There are several ways to obtain income yields well above the 1.5% gross of base rate, including:

Guaranteed income bonds

A handful of specialist life companies offer these bonds, which guarantee income for a fixed period, typically up to five years. You can choose between monthly and annual income payments, which are deemed to be net of basic rate tax. While income and the maturity value are guaranteed, if you need access to your capital before maturity, you are likely to receive back less than your original investment.

If you are a higher rate taxpayer, then at current yields you will have no income tax liability until your bond matures. Even then, the additional tax will be based on the net income you have received, rather than the equivalent gross amount (as would apply to deposit interest). However, if your gross income is £100,000 or more, the changes announced in the Pre-Budget Report could reduce the advantage of this tax deferral, so do talk to us before investing.

Corporate bond funds

While short-term interest rates have been falling, the opposite has been happening to the yields available from most fixed interest securities, other than government bonds. For example, the average rise in corporate bond yields over the 12 months to mid-December 2008 was slightly more than 2%.[2] The increase reflects a variety of credit crunch-related factors, but is seen by some commentators as creating an attractive investment opportunity.

Corporate bond funds can be held within an ISA, in which case there is no income tax deducted from the interest income.

UK equity income funds

The fall in share values has had the opposite effect on dividend yields. As at mid-December 2008, the average yield on UK shares, as measured by the FTSE All-Share Index, was 4.66%.[3] This figure is effectively net of basic rate tax. Some UK equity funds are quoting yields of more than this, but at present all quoted yields need to be treated with caution. Yields are normally calculated on an historic basis, ie based on the last year's payments. There will be dividend cuts in 2009, and not just from the banks.

Past performance is not a reliable indicator of future performance. The value of investments and income from them can go down as well as up, and you may not get back the original amount invested.

1. *Bank of England, 8/1/09*
2. *Markit iBoxx, 12/12/08*
3. *markets.ft.com, 12/12/08*

Change again to the Financal Services Compensation Scheme

The recent spate of mergers between building societies (eg the Cheshire and Derbyshire merger with Nationwide) has prompted a temporary change in the Financial Services Compensation Scheme (FSCS) rules for deposits, announced by the Financial Services Authority (FSA) in November 2008.

The £50,000 individual deposit ceiling for compensation will now apply separately to each merged society for pre-merger accountholders, provided the merged societies continue to operate under their old names. This relaxation will only last until September 2009. However, by then it is likely that the FSA will have revised the FSCS deposit rules to take account of the rapid consolidation among both building societies and banks.

Think ahead on income tax planning

Last November's Pre-Budget Report announced a variety of proposed changes to income tax and national insurance contributions (NICs) over the next three tax years.

2009/10

The main personal allowance will rise by 7.3% – more than inflation – to £6,475. The basic rate limit will also increase by more than inflation, from £34,800 to £37,400. The Chancellor's apparent generosity is countered by a substantial increase in the upper level at which full rate NICs are paid – from £40,040 to £43,875.

If you are a contracted in employee with earnings above the new upper NIC threshold, the result of these changes in the next tax year is an increase in net annual income of about £343.

2010/11

Personal allowances will be restricted for high earners in a complex two-stage approach:

1. If your gross income is between £100,000 and £140,000, your personal allowance will be reduced by £1 for each £2 of income over £100,000, subject to a maximum total reduction of half the personal allowance. So assuming a personal allowance of £6,600, your personal allowance will be halved (to about £3,300) if your income is above about £106,600.
2. If your gross income exceeds £140,000, your remaining personal allowance will be reduced again by £1 for each £2 of income over £140,000. As a result, you will have no personal allowance if your income is more than about £146,600.

These phased reductions create two bands of income around £6,600 wide, where the effective marginal tax rate is 60%, ie for each £2 of extra income you pay 40% tax on £3.

2011/12

There are two important changes due in this tax year:

- NIC rates for employees, employers and the self-employed will rise by 0.5%. For example, if you are a company director contracted in to the state second pension scheme, your personal NIC rates will become 11.5% and 1.5% (against 11% and 1% now) and your company's contribution rate in respect of your earnings will rise from 12.8% to 13.3%.
- There will be a new 45% income tax rate (37.5% for dividends) for taxable income above £150,000.

The 2011/12 tax and NIC increases (and possibly the 2010/11 personal allowance cuts) will not take effect until after the next general election. So far the Conservatives have not said that they will abandon any of the proposed measures: a projected £118bn budget deficit in 2009/10 means that the extra government revenue will need to come from somewhere.[1] In any case, in tough economic times, a pledge effectively to cut tax rates for high earners would be politically difficult.

For now, it makes sense to assume the proposals will become law and start planning accordingly:

- If you are married or in a civil partnership, make sure that you and your partner are taking maximum advantage of independent taxation.
- If you could be caught by the restrictions to personal allowances, see whether it will be possible to avoid the 60% marginal rate band, for example by transferring investment income to your partner.
- If paying 45% income tax from 2011/12 is a possibility, think about bringing forward income into an earlier tax year.
- Capital gains tax remains at 18% and gains are not treated as income for personal allowance calculations. All other things being equal, investment returns in the form of capital gains are preferable to dividend or interest income.

If you want to examine future tax planning further, a good starting point would be to raise the issue as part of your tax year end planning review.

The Financial Services Authority does not regulate tax advice.

1. *The Telegraph, 25/11/2008*

Another round on pensions

Pension Acts have become rather like London buses in recent years. After a gap from 1995, there have been three Pension Acts in the last five years. The most recent is the Pensions Act 2008, which spent over seven months working its way through Parliament.

This Pensions Act should be the last for a few years, because it marks the final primary legislative phase of the pension reforms started by the Pensions Commission ('the Turner Commission') in 2005. The most important provisions of the Act are:

Personal accounts

The personal account is the latest government initiative to encourage private pension provision. If you are an employer, no matter how small your staff numbers, personal accounts are likely to affect you.

- Any employee aged between 22 and the state pension age with earnings of at least £5,035 a year (in 2006/07 terms) must be automatically enrolled in the personal account pension scheme, if they are not already a member of a scheme that is at least as good in terms of benefits or total contributions.
- For each personal account member, the employer must pay contributions of at least 3% of *all* earnings (not just basic pay) between £5,035 and £33,540 ('band earnings' – again in 2006/07 terms).
- The employee must pay sufficient personal contributions to bring total contributions (including employee tax relief) up to 8% of band earnings. In practice, this is likely to mean that the employee pays 4%, the employer pays 3% and tax relief on the employee's contributions brings the total to 8%.
- Employees will have the right to opt out, but if they do so they will be automatically re-enrolled every three years or when they change job. The self-employed and ineligible employees (aged under 22) will have the right to opt in.
- There are strict provisions to prevent employers encouraging their employees to opt out, eg by offering more pay to non-members.

Personal accounts will be set up as a single occupational scheme by the Personal Accounts Delivery Authority (PADA), a 'non-departmental public body', and ultimately managed by an independent trustee corporation. Personal account charges are likely to be very low and initially the choice of investments will be strictly limited.

The target date for launching personal accounts is October 2012, although this is by no means fixed. In any event, contribution levels will be phased in over at least three years from launch.

Contracting out

The Act provides for an end to opting out (technically 'contracting out') of the state second pension scheme (S2P) by way of personal pensions or money purchase occupational schemes. No date has yet been announced, although the expectation is that it will be April 2012, when the current five year set of national insurance rebates expire.

To some extent, this is only recognising the inevitable. Contracting out rebates are relatively unattractive. They have already encouraged many people to join (or rejoin) S2P.

If you are a member of a final salary (defined benefit) contracted out scheme, the change will not affect you, although it remains to be seen how long the government will keep this option open.

Preserved pensions

If you leave a final salary scheme after 5 April 2009, eg on changing job, the Act will reduce the statutory inflation protection given to part of your pension benefits. For all benefits accrued after that date, the statutory increase until retirement will be the lesser of inflation and 2.5% a year, compared with the present ceiling of 5%.

If you need help in planning for these changes, let us know. Levels and bases of, and reliefs from, taxation are subject to change and their value depends on individual circumstances.

Income shifting legislation delayed

If you are a shareholder-director in your company with your spouse or civil partner, you may be thinking about declaring dividends at this time of year and taking advantage of certain tax-saving benefits. Expected legislation in the wake of the 'Arctic Systems' case to curtail the tax efficiency of 'income shifting' in this way has yet to be enacted.

There are many companies where the spouse (or registered civil partner) of the main person running the company receives some shares, either by gift or, perhaps, by purchase. This arrangement is made so that the spouse or civil partner can receive dividends and be taxed on them at a lower rate than the prime income generator behind the business. Such planning was made possible by the introduction of independent taxation in the early 1990s. The Arctic Systems case threatened to make such arrangements unlawful.

Arctic issue

The case, officially *Jones v Garnett*, involved the shareholders, Mr and Mrs Jones, of a small private limited trading company. Each held one share in the company, purchased for £1. Mr Jones was an IT specialist who did the work that brought in the fees, while Mrs Jones worked part time as company secretary and administrator.

The company paid part of its profits out as dividends in an attempt to reduce the impact of income tax on moneys extracted from the company, and also to try and avoid employer's and employee's national insurance contributions (NICs) on the profits involved.

For one year in which the Jones' both took salaries of around £20,000 and the balance of the income they needed as dividends, HM Revenue & Customs (HMRC), then the Inland Revenue, challenged that Mr Jones should pay income tax on *all* of the dividends, on the basis that the 'arrangement' surrounding the shares constituted a 'settlement' in which he had an interest.

The House of Lords eventually found in favour of the Jones' in a judgment delivered on 25 July 2007, much to HMRC's and the government's dismay. HMRC had seen this as a test case leading to increased revenue – if it had won, this could have led to it assessing many more couples (whether married or in registered civil partnerships) in companies where one of the parties could be seen as doing a larger share of the work.

Hold on legislation

Immediately after the case, the government vowed to bring in legislation to close what it and HMRC regard as a loophole in the tax system. The legislation was promised to be effective for tax year 2008/09. Following consultation, it was thought that the new rules would now be in place, to be effective from tax year 2009/10.

In the event, this has not materialised – the legislation has been further delayed and it is not known when it will be enacted. It could be in force from tax year 2010/11, but this is still unclear.[1]

For shareholding directors of companies in a similar situation, it should still be possible to take dividends and be taxed individually on those dividends in the proportions in which they are received, at least for the next tax year. HMRC could bring another case to court with slightly different circumstances than those in the Arctic Systems case, but, with legislation on the way, this is thought to be very unlikely.

However, it could be prudent to be careful when choosing the size of the dividends declared. If you need guidance, let us know. The Financial Services Authority does not regulate tax advice.

1. *HMRC, Pre-Budget Report 24/11/08*

Benefits of sacrifice?

The latest round of state pension reforms as set out in November's Pre-Budget Report starts from 6 April 2009. If you are an employee:

- The ceiling for full rate national insurance contributions (NICs) will rise by £74 a week (see page 4); but
- The upper earnings level for state second pension (S2P) benefits, or the corresponding contracting out rebates, will be frozen.

If you earn more than the new upper full rate NICs limit (£43,875 a year) and are under state pension age, you will pay 11% NICs on about £3,850 of earnings for which you accrue no state pension-related benefit. Matters become worse if you have fringe benefits, such as a company car, which restrict your PAYE tax code. You could find that part or all of that £3,850 band of earnings is also subject to 40% income tax.

The combined effect of 40% income tax and 11% NICs means that, at the margin, you could be left with 49p for each £1 of pay. This can be turned to your advantage if you use salary sacrifice to boost your pension contribution, as the example opposite shows.

Even though salary sacrifice can be highly tax-efficient, it is not suited to everyone. Sacrificing salary reduces your earnings and could limit your ability to borrow. So do ask for advice before you make any changes. The Financial Services Authority does not regulate tax advice. The levels and bases of, and reliefs from, taxation are subject to change and their value depends on individual circumstances.

40% + 11% = 51%

In 2009/10, Graham will earn £43,500. He has a company car with a taxable value of £3,500, so his net allowances are £2,975 (£6,475 – £3,500). His cash earnings are taxed under PAYE at the following rates, assuming he is not contracted out of S2P:

Earnings Band	Income Tax	NICs	Combined Rate
£0 - £2,975	0%	0%	0%
£2,975 - £5,715	20%	0%	20%
£5,715 - £40,375	20%	11%	31%
£40,375 - £43,500	40%	11%	51%

If Graham sacrifices £3,000 of his gross salary in favour of a £3,000 pension contribution made by his employer, he will save £1,530 in higher rate tax and NICs – the equivalent of receiving 51% tax relief. He will not lose any S2P benefits, and he might be even better off if his employer allows for some or all of their £384 NIC savings.

Trustees’ tax rate going up to 45%

One surprise in the Pre-Budget Report on 24 November 2008 was the proposed increase in the income tax rate for those with income of more than £150,000 to 45% on the excess over that figure, to take effect from 6 April 2011.

Just as important for those affected is the increase to the trustees’ income tax rate, also from 40% to 45% from the same date.

The impact, where relevant, will be even greater for trustees, because it will apply to all income over £1,000 (unless that limit is increased by a further announcement). The change will mainly affect trustees (and, without planning, beneficiaries) of discretionary trusts.

Trustees of these trusts should consider the use of single premium bonds as trustee investments, which could serve to reduce the impact of the change, particularly where existing trust investments are dividend-producing. The assignment for no consideration of segments of these bonds to beneficiaries at the appropriate time is likely to produce even further tax savings.

The current state of the stock market, plus the low capital gains tax rate of 18%, means that urgent action should be considered.

This is a complex area and guidance is essential. The Financial Service Authority does not regulate tax advice.

Nil rate band rises

Did you know that from 6 April 2009, the inheritance tax (IHT) nil rate band will rise by £13,000 to £325,000? The increase, which was announced by Gordon Brown in his 2006 Budget, is less than would have occurred if the normal indexation rules had applied. However, the opposite is likely to be true in April 2010, when the nil rate band is set to reach £350,000.

Given the fragile state of the government’s finances, the chances of IHT disappearing soon look very unlikely. If your estate exceeds the nil rate band, make sure your IHT planning is up to date. The Financial Services Authority does not regulate tax advice.

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Back to work with new allowance

Do you know what the new Employment and Support Allowance (ESA) is?

It might sound like another initiative to keep down the unemployment numbers, but in fact it is a replacement for incapacity benefit (IB), introduced for new claimants from 27 October 2008. Anyone who meets the eligibility criteria will receive ESA if they are unable to work because of illness or incapacity. If you are employed, you will normally receive at least statutory sick pay from your employer for the first 28 weeks of absence from work, after which ESA takes over.

Focus on employment

One of the major changes from incapacity benefit is that ESA is more focused on finding employment for claimants. Thus the first stage of the new benefit is an 'assessment phase', normally lasting 13 weeks, during which time the Department for Work and Pensions (DWP) undertakes a 'Work Capability Assessment' for the claimant.

The DWP says that this 'assesses what an individual can do – rather than what they can't do'. It also states that in the second stage 'following this assessment, most individuals will be given support and employment advice to enable them to return to work where possible'. There is a lower benefit rate for such claimants, who are required to carry out 'work-related activity' to receive their full ESA payment.

If you do not have any existing income protection cover, ESA's arrival should prompt you to reconsider arranging some protection. The thrust of ESA is to make you work unless you are very seriously ill or disabled. That could reduce your chances of returning to your original job and/or restrict a necessary period of convalescence.

Review your protection

If you do have existing income protection, then it may now be inadequate. Traditionally, the maximum benefit under an income protection plan has been calculated after allowing for long term IB. Both the new two-stage approach and stricter conditions for payment mean that you should consider increasing your cover to allow for the loss of IB.

Similar issues arise if you are an employer with a group income protection plan for your employees. Unless the plan is amended to take account of ESA, you may discover your employees' total level of replacement income has effectively been cut.

Not so premium bonds

The fall in interest rates has not only been hitting the returns available from bank and building society deposits. National Savings & Investments (NS&I) has also been cutting its returns.

A good (and rather invisible) example of how NS&I has been reducing rates is the interest rate used to calculate the prize fund for premium bonds:

- At the start of 2008, the prize fund was calculated as 3.8% of the amount invested in premium bonds. Twelve months later, the rate has fallen to just 1.8%.
- Over the same period, the chances of a win in any one month have been reduced from 21,000:1 to 36,000:1
- The spread of prizes has changed, too. In January 2008, 86% of the prize fund was spent on wins of £50 or £100. Now 95% goes towards these small prizes. In January 2009, only 258 out of over 1,080,000 prizes were worth £1,000 or more. And NS&I are now talking about introducing £25 prizes.[1]

If you are a basic rate taxpayer, 1.8% tax-free is worth 2.25% in terms of gross interest, while if you are a 40% taxpayer, the prize rate is worth 3% gross.

You could be better off leaving your money on deposit.

1. *NS&I, 18/11/08, 02/01/09 and 21/1/09*

Rob Sandwith, Chief Executive

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