financial focus

Summer 2012

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Jubilation?

The Queen's Diamond Jubilee celebrations have highlighted so much of what is great about our country, and indeed our monarch. At 86 and supposedly 21 years into 'retirement', the Queen remains the best advert for our nation and the work ethic that historically built so much of this country's success.

A healthy work ethic and desire to create wealth, rather than sponge of the state, are perhaps attributes that polarize the two ends of the Queen's reign and highlight some of the main issues challenging governments and individuals now. In 1952 the State Pension was roughly a third of what it is today. We're paying ourselves three times more in real terms and living longer: a recipe for ruin?

Yes and no. In real terms, GDP has risen faster than the population, so on a per-capita basis, we are much richer now than when Elizabeth came to the throne and we can, in some senses, afford such largesse. The tax burden relative to GDP is around the same as it was then, but of course the way it is spent has changed – defence spending has shrunk drastically, while that devoted to health, education and notably welfare has risen sharply.

Government debt, thanks to the 2008 bank rescues, is also at similar levels to 1952. But the big change is private debt where at the end of 2011 consumer debt excluding mortgages exceeded £200bn. In 1952 consumer debt was confined to tick at the corner shop. House prices are now 86 times higher – the average property then cost £1,891 and now costs £162,722. Wages are about 60 times higher.

Consumers are deleveraging very slowly while government debt is still rising. Only the corporate sector is flush, and it's this rather than government spending that holds the key to recovery. At some point, companies will have to start spending that money, or handing it back to shareholders. Only then can the economy really start to recover.

Our client Golf Day at St George's Hill Golf Club fell on the year's nicest day so far!

The recent dip in markets has provided another chance for investors with the appropriate risk appetite (and a medium term outlook) to convert cash-based investments earning negative real returns into equity funds. On almost any valuation basis, the equity market looks very good value at current levels (the FTSE is on a PE of 10.5 times underpinned by dividend yields of 4% plus in many instances).

Please contact us to discuss any of the articles featured in this newsletter and we wish all our readers a great summer – assuming the sun makes an appearance soon!

Rob Sandwith | Chief Executive

In this issue: Budget changes and reversals roll out • Tax saving strategies for married couples and civil partners • Time to tackle low interest rates? • Final curtain for protected rights pensions • Take cover now • Here comes auto-enrolment

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‘The many rumours on pension tax relief proved to be wrong...’

Budget changes and reversals roll out

The final shape of the 2012 Budget was still being settled months after George Osborne made his statement in March.

The Budget provoked a wave of protests from those affected, some of which have caused the Government to back down: pasty-eating, caravan-loving philanthropists can feel mightily relieved. In truth, a good many of the Budget provisions had already been announced earlier or leaked. But there were some surprises, nevertheless.

Income tax

The major news was the reduction in the additional rate of tax to 45% (37.5% for dividends) from 2013/14. The cut will also apply to trusts, which normally pay tax at the top rate. If you are currently a 50% taxpayer, then you should already be considering how you can push income into next tax year when it will be taxed at 5% less, while maximising tax reliefs in 2012/13.

More significant in terms of the number of people affected was the announcement of a £1,100 increase to £9,205 in the personal allowance for 2013/14, accompanied by a £2,125 reduction in the size of the basic rate band. The end result will be more non-taxpayers and more higher rate taxpayers.

The Chancellor also revealed a 'major simplification' of age allowances, which actually means they'll be phased out over the next few years.

If you were born after 5 April 1948, you will not receive an age allowance when you reach 65. If you already receive an age allowance, generally it will be frozen at current levels (£10,500 for those under 75, and £10,660 for those 75 and over) until it is overtaken by the rising personal allowance.

Child benefit

Ahead of the Budget, there were many rumours about how the Chancellor would soften his 2010 proposal to remove child benefit from any family in which a parent was a higher rate taxpayer – even if it was to a trivial extent. The Chancellor's solution was to introduce a new 'high income child benefit charge' at a starting point of £50,000 of income. This income tax charge is equal to 1% of the child benefit paid to a family for each £100 of income over £50,000 received by the person with the highest income.

For example, if your income is £54,000, you will pay tax of 40% of the child benefit your family receives. For a family with two children, that would amount to tax of £700 in a full tax year. If your (or your partner's) income is £60,000 or more, the tax charge will equal the child benefit and so wipe it out altogether.

The new tax will apply from 7 January 2013, three quarters of the way through the current tax year, so its full impact will not be felt until 2013/14.

The definition of 'income' used to determine the tax charge does offer some opportunities for planning. For instance, a pension contribution will reduce your 'income'.

Company cars

The company car has become a taxation target in recent years, and the 2012 Budget was no exception. The Chancellor announced planned tax increases for three tax years, starting in 2014/15 – next tax year's increases have already been decided.

There was one small piece of good news, if your company car is a diesel: the supplement charged on diesel cars is to be abolished – but only from April 2016.

Pensions

The many rumours on pension tax relief proved to be wrong: the Chancellor did not limit relief to basic rate, nor did he cut the annual allowance further. At least, not this year…

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Did you know that company car owners with diesels will benefit from the removal of the 3% supplement from 2016? But, the Chancellor announced other company cars in all bands will go up by 1% in April 2014 with a further 2% increase in both 2015 and 2016. Drivers of small cars will be hit harder, with electric cars or hybrid owners feeling the effects of the change most of all. Those with company cars that emit less than 75g/km of CO_2 currently don't have to pay any tax. In three years' time they will be hit with a tax on 13% of the value, rising to 15% the following year. Diesels could prove increasingly popular for those making their next company car selection.

Tax saving strategies for married couples and civil partners

Families can have more opportunities for tax planning than most people realise. If you make the most of your tax allowances and lower tax rate bands, the result could be more cash for spending or a welcome boost to the value of your savings.

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There have been a number of important changes recently that have opened up new opportunities. The basic principle is that husbands and wives are taxed as separate, independent individuals in virtually all respects.

Personal allowances Nearly everyone is entitled to a personal allowance, worth £8,105 in 2012/13, rising to £9,205 next tax year. The first port of call for tax planning is to cover both your and your spouse's personal allowances, which this tax year would mean a total of £16,210 tax-free income. If you run your own business, then employing your spouse can be an effective way of covering at least part of their personal allowance.

The same principle of not wasting allowances applies if either of you are aged 65 or over by 5 April 2013 and eligible for age allowance. However, as we explain in 'Budget changes and reversals roll out' age allowance will not be with us much longer.

The personal allowance is phased out at the rate of £1 for each £2 of income above £100,000, an effective tax rate of up to 60% in the band between £100,000 and £116,210. So even if both you and your spouse are higher rate taxpayers, rebalancing income between you could cut your overall tax bill. Rebalancing may be possible by transferring income-producing investments from one spouse to the other. If you both work in a business, you may be able to change the way you are paid, but you need to be able to justify the payment levels.

Tax bands The 10% tax band for savings income, the recent reductions in the higher rate threshold and the introduction of the additional (50%) tax band all mean that there are tax savings that can be made by rebalancing income between a couple, as the example below shows.

The value of independence

Jane is a higher rate taxpayer with an income of £60,000, including gross interest of £2,000 on gilts she inherited from her father. Her husband, Howard, is a basic rate taxpayer with an income of £35,000. If Jane transfers her gilt holding into Howard's name, her tax bill would fall by £800, while his would rise by only half as much.

Child benefit The new child benefit tax (see 'Budget changes and reversals roll out') is a further incentive to do some more tax planning. At the extreme, a couple with £100,000 joint income divided equally between them would not suffer the tax, while if their income split was £60,000/£40,000, the tax would wipe out their child benefit. So, again, it could pay two higher rate taxpayers to rebalance their income, even if they both remain in the 40% band.

Capital gains tax (CGT) There are two main aspects to planning for CGT, both of which echo the approach to income tax. The first is to make sure you both use your £10,600 annual CGT exemption. The second is to watch the tax bands. Capital gains beyond the annual exemption suffer only 18% tax to the extent they fall within the basic rate band and 28% in the higher and additional rate bands.

The same rules apply for civil partners as for married couples, but if you are not married matters can become more complicated. Transfers of investments could create CGT and inheritance tax liabilities.

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If you prefer a paper return, have you remembered that you need to file it now? If you're someone who shuns online, then don't delay – the 31 October paper tax return deadline is not far off and leaving it to the last minute is a dangerous game. Fines start from £100 for late filing, even if no tax is due. After three months, if a return isn't made and tax not paid, there's a £10 a day fine, up to 90 days or £900 in addition to the £100 fixed fine. After six months, £300 or 5% of the outstanding tax, whichever is higher, will be charged. HMRC can also levy penalties of up to 30% for any careless mistakes. Penalties rise to 70% of the tax due for 'deliberate' misstatement, and then to 100% for misstatements that are both deliberate and concealed.

Time to tackle low interest rates?

A recent Confederation of British Industry (CBI) forecast suggested that interest rates in the UK will remain at their record low of 0.5% until the final quarter of 2013.

This is just one opinion, but a number of commentators seem to think that any rises are some months away for investors. No wonder most investors are anxious about their savings – especially if they are depending on them for income.

With interest rates on the better yielding deposit accounts producing a little more than 3%, returns are not enough to cover the eroding impact of inflation at 3.5%. Even before income tax, savings that earn an annual 3% are slowly losing their value at the rate of half a per cent a year. After basic rate tax, the net annual return is only 2.4% and for a higher rate taxpayer the net yield is a miserable 1.8%.

Of course, cash has its place in pretty much every portfolio. It is especially useful for short-term needs and emergencies. And cash deposit accounts are a good home for money that is waiting to be invested. Deposit accounts have the advantage of easy accessibility and knowledge that at least the nominal value of the cash will not go down – although its real value has been declining, even if you have reinvested the interest on your savings each month. Based on past performance, cash has seldom produced high positive returns for investors, especially after tax and inflation. But many people feel they do not want to invest in assets like shares or property whose value can suddenly fall.

However, there are also many investors who are prepared to consider investments that produce a higher income and possibly also the prospect of growth in their income and the capital from which it is derived. The possible downside risks are that the income and the capital may go down and they may not get back the money they invested. So what are the main types of investment you should consider if you are prepared to switch at least part of your savings out of cash deposits?

- The first asset class you might want to consider is shares. For example large companies in the UK, US and around the world are generating attractive dividends for investors. Diversification is vital, so you need to spread your money over a range of companies, sectors and economies. Most people should invest through collective investments rather than buy shares direct. By pooling assets in this way, investors can access a range of assets that can be aligned to their attitude to risk.

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- UK gilts and most other securities issued by governments of stable developed countries are yielding very little. But corporate bonds – fixed-interest securities issued by companies – can provide higher incomes. Bonds are generally less volatile than shares, but they can also produce losses as well as gains.
- Property is another asset class that can generate a relatively high income. Commercial property investment in offices, shops and other real estate is generally cyclical and this may be a good point in the UK property cycle to consider investing.

There is a choice of tax wrappers through which you can invest in these different asset classes, including ISAs, pensions, collective investments and onshore and offshore life assurance policies. The right ones for you will depend on your individual circumstances.

Past performance is not a reliable guide to future performance. The value of your investments and the income from them can go down as well as up and you may not get back the value of your investment. If you invest in property there may be a delay in withdrawing your capital, even from a pooled investment.

ISAs are not just for tax year ends

Now that 5 April has passed, ISA publicity has faded from the press. Yet now is the time to invest.

One of the most reliable signs of early spring is the blossoming of ISA ads and supplements in the weekend press. However, by mid-April a financial frost removes virtually any trace of ISAs for another year. It makes little sense, as theoretically the optimum time to invest in ISAs is at the start of the tax year. The earlier you invest, the longer there is to benefit from the tax advantages of an ISA. Even if you cannot make the new maximum £11,280 investment now and in full, there is still a sound financial logic to an early start with some contribution.

The value of your investment and the income from it 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 should be regarded as a long-term commitment and should fit in with your overall attitude to risk and financial circumstances. The value of tax reliefs depends on your individual circumstances. Tax laws can change. The Financial Services Authority does not regulate tax advice.

Final curtain for protected rights pensions

The rules for contracting out of the state second pension (S2P) have changed – and some of the news is good. If you have any 'protected rights' pensions, you may need financial advice.

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When personal pensions were first launched in 1988, one of their most important features was that they gave the individual employee the ability to opt out (technically 'contract out') of the second tier of state pensions, then called SERPS. Until then the only way you could opt out was through membership of your employer's occupational scheme – if your employer had a suitable scheme.

Initially, the government made personal pension contracting out an attractive option by providing incentive payments and a substantial flat rate contribution, regardless of age. However, over time the incentives disappeared and the contribution became age related, less generous and eventually capped. By the time SERPS was replaced by the subtly different S2P in April 2002, in most cases the advantages of contracting out through a personal pension were marginal, at best.

Ten years on from the start of S2P, the option of using a personal pension to contract out of S2P has been withdrawn. If you were contracted out by either in the tax year 2011/12, then from 6 April 2012 you will have automatically become a member of S2P.

If you contracted out through a personal pension, you will not notice any difference in your national insurance contributions as a result, but no further contracted out payments will be made to your personal pension, other than those due in respect of 2011/12.

The funds built up by the contracted out payments – from whatever source – remain invested in your pension arrangement, but they are no longer subject to special treatment as 'protected rights'. This is mostly good news. For example, the requirement to provide for dependant's pensions is no more.

You may wish to talk to us about whether you should be taking any special action with respect to your protected rights pension fund. What the changes mean to your retirement benefits is difficult to say, not least because the Budget confirmed that a new single-tier state pension, replacing the basic state pensions and S2P, is to be introduced 'early in the next Parliament'.

A pension is a long-term investment, and the fund value may go down as well as up. Your eventual income may depend on the size of the fund at retirement, future interest rates and tax legislation.

Did you pay attention to the Budget's details? One of the less-publicised surprises in the Budget was a new limit on the total annual contributions that can be paid to maximum investment plans (MIPs) and similar investment-based life assurance policies. MIPs in particular had started to attract attention because of the various restrictions on pension contributions. The precise measures will not be finalised until 2013, after consultation later this year. The new limit of £3,600 a year is proposed to take effect from 6 April 2013 with transitional measures for policies taken out between 22 March 2012 and then. One point to emerge so far is that policies issued before 21 March 2012 will not be affected, provided their premium payment term is not extended. So, if you have a MIP, make sure you take advice before making any changes.

Take cover now

Legal changes could increase the cost of life and health cover. If you have not reviewed your life and health cover for a while, there are two good reasons why now is a sensible time to do so.

The first is inflation: prices, as measured by the Retail Prices Index, are now nearly 20% higher than they were at the beginning of 2007. All other things being equal, your cover should have increased similarly. The second reason is legislation: two changes that are due to take effect from around the end of the year are likely to lead to some increases in the cost of new life and health protection policies.

- From 22 December 2012 it will no longer be possible for an insurer to charge different premium rates for any newly arranged insurance policy purely on the grounds of sex. So women and men will pay the same premium for life assurance (and car insurance), even though the statistics show that women are generally a better risk. The change is a result of a European Court judgment in March 2011.

  The Treasury estimates that for women, term assurance policy rates could increase by 10%–15%, while critical illness cover could cost 12% more. In theory, the corresponding men's premium rates should fall, but by much less than the increase for women. The lack of symmetry is down to the fact that more men arrange protection cover than women, so an average 'unisex' premium is closer to today's male rate rather than midway between male and female rates.

- From 1 January 2013 the taxation of life companies – an arcane subject at the best of times – will be reformed. This will result in companies having less scope to claim tax relief on their expenses, which is expected to lead to an increase in premiums for new protection life assurance policies.

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If you would like a review of your protection cover or a quotation for specific new or replacement cover, do contact us as soon as possible. While the legislative revisions are due at the end of 2012, it is possible insurers will start making changes well ahead of the festive season.

The value of your investments and the income from them can go down as well as up, and you may not get back the original amount invested.

IHT changes set to boost charity donations

New rules are being introduced in the Finance Bill – expected to pass into an Act in July – which will mean the rate of inheritance tax (IHT) that heirs must pay can be reduced if more than 10% of an estate is left to charity.

The change took effect from 6 April when the Government introduced new IHT legislation. Gifts to charity are already exempt from IHT, but the new rules mean the rate of IHT on the rest of the estate can fall from 40% to 36%.

The tax break has been welcomed by charities, who believe the move could help shore up dwindling finances and act as an incentive. So, this could be a reason to consider changing a will – but the rules are complex and advice should be taken on what the options are and drafting the will correctly.

In a nutshell, however, the 10% 'test' now applies based on the total value of the net estate for IHT purposes, after deducting any available nil rate band (currently £325,000), any spouse exemption and reliefs, such as agricultural property relief and business property relief.

The purpose of the change is not meant to benefit any beneficiaries and they may receive less if a will is changed in favour of a charity. However, it is about mitigating tax payable, and will be good news for those who take their social responsibilities seriously.

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Wake-up call for your dormant accounts

Money from bank customers' dormant accounts has now been transferred to the Government's Big Society Bank, but account holders can still get it back if they can prove ownership.

The bank's money, £400 million of which comes from dormant bank accounts that have been left unused for at least 15 years, will be lent to social enterprises and charities but remains the property of the customer. Since 2009, the Government has been able to take control of money left untouched for 15 years. However, while the definition of 'dormant account' varies from bank to bank, most declare untouched accounts 'dormant' after either a year or three to five years.

If you remember a bank account that you have not used for 15 years or more, you should contact the bank to check what has happened to it and gather any documentary evidence that the money is yours. Banks have been trying to trace owners of dormant accounts since the Big Society Bank was announced in early 2011, but if you have forgotten about an account, the bank might not have your current address.

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If you are unsure where you held an account, there is a free central tracing scheme spanning banks, building societies and NS&I, including instances where the bank or building society has closed or merged. You can download a claim form at www.mylostaccount.org.uk and you should receive a response within three months. You will still have to prove ownership before the bank reactivates any account found.

Here comes auto-enrolment

In less than six months' time, pension auto-enrolment will begin.

From 1 October 2012, the Government is starting the introduction of auto-enrolment, which aims to improve the living standards of millions of people when they retire. Auto-enrolment is a way of making sure that all eligible employees automatically become members of a pension scheme with at least a minimum set level of contributions. Employers will have a major role and a number of new obligations involving additional expense and administration. If you are an employer, you will have to ensure that your company's approach to pensions meets the new legislation. If you already have a pension scheme, you will need to make some changes to it. Otherwise, you will need to set one up.

The introduction of auto-enrolment starts with the very largest employers this October and then gradually extends to smaller organisations. It will probably not be until October 2018 that this stage is reached, because the Government has decided to phase in both the auto-enrolment process and the level of contributions. Even that final date is not yet set in stone because a consultation on timings has not ended. For businesses with less than 250 employees, auto-enrolment is not scheduled to begin until April 2014 at the earliest.

By the time auto-enrolment is fully in force, virtually every employee aged between 22 and state pension age with earnings at least equal to the personal allowance (£8,105 in 2012/13) will either be a member of a pension arrangement to which their employer contributes, or have chosen to opt out. Total contributions (in 2012/13 terms) will be a minimum of 8% of pay between £5,564 a year and an upper limit of £42,475, of which the employer must pay at least 3% and the employee the balance.

If you are a small employer, 2014 might seem far enough away to forget about, but our advice is to begin planning now. The Department for Work and Pensions has started an £11 million national advertising campaign on workplace pensions and auto-enrolment, so your employees may start asking questions soon. Auto-enrolment will usually mean payroll changes, not to mention a decision about whether to use NEST or another pension scheme.

Tax and pensions laws can change.

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