financial focus

Summer 2009

rosan helmsley

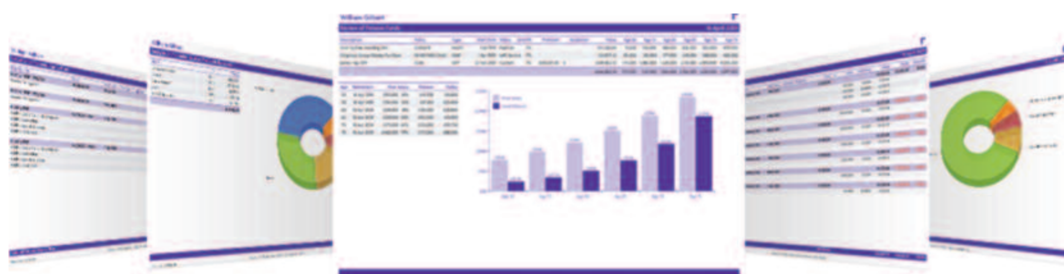
Budget calls for summer planning

The April 22nd Budget was a shock to many, but we should not be surprised by much of its content given the parlous state of UK finances. In its taxation plans for next year, this Labour government has now revealed its true socialist colours and will not, I suspect, be judged kindly when the history books are written.

Having presided over the highest taxation revenue of any administration in history, it is scandalous to find that the UK's fiscal position is worse than many countries regarded as 'emerging'.

The key to starting an economic revival is of course to encourage capitalism, free trade and entrepreneurialism – not stifle them through the taxation proposals tabled. Needless to say, some of the proposals in the budget (particularly those regarding pension amendments) are going through a period of consultation. We are unlikely to see any turnaround on the changes proposed, but it does seem a remarkably politicized move to turn many of the laudable changes instigated by the government on 'A-Day' – April 6th 2006 – the day that heralded 'pensions simplification', and replace them with new layers of complexity.

On a positive note, we will shortly be launching the latest version of our online reporting service, including better charts, asset allocation and much clearer valuation summaries. These will also manifest themselves in the paper-based schedules.



Expect new valuation reports through 2009

Finally, on May 29th we held our annual Golf Day at St George's Hill Golf Club, an event designed to remind everyone of the value of personal professional relationships. We shared a memorable day with clients from a diverse range of industries and professions.

Client Golf Day – St George's Hill Golf Club

I hope all our readers have a great summer and please contact us if you require further information on any of the articles in this newsletter.

Rob Sandwith | Chief Executive

In this issue: Caught by the Budget tax trap? • ISA limits finally on the rise • Covering long-term care • Higher rate relief melts away • Protecting your business

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 May 2009.

Caught by the Budget tax trap?

The Chancellor revealed restrictions on higher rate tax relief for some pension contributions, making 50% relief unobtainable.

Alistair Darling's second Budget contained more than the usual share of surprises. Although last November's Pre-Budget Report (PBR) had seemingly trailed most of the spring Budget's content, the deterioration in the UK's economic condition since last autumn forced the Chancellor to strengthen some of his tax-raising measures.

The major surprises revolved around the new top rate of income tax. This was set out in the PBR as a rate of 45% for income above £150,000 from 2011/12. The Budget proper increased the rate to 50% (42.5% for dividends) and brought forward its start to next tax year. In parallel with this, the Chancellor revealed restrictions on higher rate tax relief for some pension contributions, making 50% relief unobtainable. These measures are considered further in 'Higher rate relief melts away' on page 6.

From 2010/11, the new 50%/42.5% rates will also apply to all income of discretionary and accumulation trusts above the standard rate band, which was unchanged at a maximum of £1,000. The move continues the ratcheting up of trust taxation which has been a feature of recent Budgets.

The phasing out of the personal allowance for high income individuals was another PBR proposal that was amended to provide more revenue for the depleted government coffers. From 2010/11, your personal allowance will be reduced by £1 for each £2 by which your total income exceeds £100,000. The example at right shows how this will operate in practice.

From 2011/12, all the main rates of national insurance contributions (NICs) will rise by 0.5%. This measure – an income tax increase in all but name – will raise double the revenue of the 10% top rate tax increase.[1]

Now is the time to start reviewing your affairs if you could be caught by these tax changes. For example, it could make sense to increase this year's income – perhaps bringing forward a dividend payment – because the top tax rate is still 40% in 2009/10. You may also want to consider rearranging investment holdings to move income between you and your spouse or civil partner – independent tax planning now matters even if you are both higher rate taxpayers.

On the business tax front, the small companies' rate for corporation tax has been held at 21% for this financial year, but will rise to 22% in 2010. A 1% increase in corporation tax against a 10% increase in the top rate of tax could mean that, if you are self-employed, incorporation has become a more attractive option. The company structure also allows income to be drawn as dividends, which are not subject to NICs. A new 40% first-year capital allowance was introduced for all types of business, lasting until next April. There were no anti-avoidance measures directed at 'income-splitting' between spouses and civil partners, but HM Revenue & Customs confirmed that it is keeping the issue under review.

The value of tax reliefs depends on your individual circumstances and may be subject to change in the future.

1. HM Treasury, 'Building Britain's Future', 22/4/09, Tables A1 and A2

Losing the personal allowance

In 2010/11, Stephen has a total income of £108,000. Assuming the basic personal allowance is unchanged at £6,475, Stephen's reduced allowance will be:

	£
Basic personal allowance	**6,475**
Reduction: $\left[\frac{£108,000 - £100,000}{2}\right]$	**4,000**
Remaining allowance	**2,475**

If Stephen were to receive another £2,000 of earned income during the year, he would pay £800 tax on this income. At the same time, he would lose another £1,000 of his personal allowance, adding another £400 to his tax bill. Thus his extra £2,000 income would increase his tax bill by £1,200, an effective marginal tax rate of 60% – higher than the new top rate. Only once his income exceeds £112,950 and his personal allowance is fully extinguished will he return to being a 40% marginal rate taxpayer.

For £50, read £25

From 1 April, National Savings and Investments worsened the terms for premium bonds. It was the first change since January. The prize fund interest rate was cut from 1.8% to just 1% and the minimum prize – which accounts for over 96% of all prizes drawn – was halved to £25. The odds of winning were kept the same – 1 in 36,000 – but there is now only a single one million pound prize each month.[1] The theoretical 1% net return is easily beaten by many internet instant access accounts.

1. NS&I, Press Release 18/3/09

ISA limits finally on the rise

One welcome surprise to emerge from the Budget was the increase to individual savings accounts (ISA) investment limits. This was long overdue.

When ISAs first appeared in April 1999, the initial maximum total contribution was £7,000 per tax year. Nine years later this was raised by just £200, an addition that did virtually nothing to compensate for inflation over the intervening period. The new increase announced in the 2009 Budget was a more useful £3,000, bringing the maximum total ISA investment to £10,200 per tax year. The corresponding limit for the ISA cash component has also risen, to £5,100.

The way in which the new limits will operate is not straightforward. The new £10,200 ISA ceiling will be available from 6 October 2009, if you were born before 6 April 1960, ie you are aged 50 or over by 5 April 2010. Otherwise, the higher limit will not apply until 2010/11.

At a time when taxes are increasing, ISAs offer one of the easiest ways to reduce HM Revenue and Custom's slice of the return from your investments.

There is another non tax-saving ISA feature that can be valuable in terms of time (and accountancy costs): nothing to report on your tax return.

An ISA investment early in the tax year, rather than in the use-it-or-lose-it rush next March, means you start benefiting from the ISA's favourable tax treatment earlier. If you do not have the cash available at present, it may make sense to 'bed-and-ISA' existing investments. This involves selling investment(s) and then repurchasing them within an ISA. The capital gains tax anti-avoidance rules introduced in 1998 to counter 'bed-and-breakfasting' – personally selling shares one day and then repurchasing the next – do not apply to 'bed-and-ISA'.

If you have existing holdings in cash ISAs, it is well worth checking what interest rate you are currently earning. The fall in base rates over the past year has left some instant access cash ISAs paying rates of 0.25% and less. At such a very low level, the freedom from income tax on interest does not count for much. Since April last year, it has been possible to transfer cash ISAs into stocks and shares ISAs (but not vice versa). Moving from a cash ISA to a stocks and shares ISA invested in a corporate bond fund could offer a substantial increase in tax-free income, although you should remember that you would lose the capital security that a cash ISA provides.

Past performance is not a guide to future returns. 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. Levels and bases of, and reliefs from, taxation are subject to change and their value depends on individual circumstances.

ISA feature	Maximum tax savings
Any income generated does not figure in any of the total income calculations for the new pension tax relief rules or next tax year's phasing out of the annual allowance	**60% from 2010/11 if income falls into the band where the personal allowance is phased out**
Interest from deposits in cash ISAs and from fixed-interest securities in stocks and shares ISAs is free of UK tax	**50% from 2010/11 for a new top rate taxpayer**
For stocks and shares ISAs, there is no additional UK tax on dividends, although the 10% tax credit cannot be reclaimed	**32.5% from 2010/11 for a new top rate taxpayer**
All gains are free of UK capital gains tax	**8%**

Covering long-term care

Long-term residential care can be very expensive. Local authorities must carry out financial assessments of those going into residential care, and the residents are charged what they are assessed as being able to afford. This means that many residents pay for their care in full unless they have extremely limited amounts of income and capital. And capital often includes the value of their former home.

For 2009/10, the assessment allowances and limits are:

- A weekly personal expenses allowance (PEA) of £21.90 (£1,138.80 pa), that the local authority deducts from the resident's income.
- Residents must contribute to the total cost of their care until their capital reduces to £23,000.
- Once the individual's capital reduces to £14,000 it is disregarded, and no further contribution is necessary.
- Between £23,000 and £14,000, the local authority will again assess what an individual can afford to pay under what is known as 'tariff income', ie the local authority will take into account as weekly income £1 for every complete £250 or part of £250 of capital over £14,000.
- The capital value of a resident's home counts towards these limits, unless the property continues to be the home of the resident's spouse, civil partner, or certain relatives. The value is disregarded for the first 12 weeks after admission into the care home.

An immediate care plan should be considered when it becomes apparent that someone needs residential care, as it may limit the amount of capital that has to be spent on care home fees.

After three months, the local authority can take a charge on the home, in which case fees will eventually be paid out of the proceeds of the property sale. This effectively represents and interest-free loan from the local authority. As a general rule, in these circumstances the care component of disability living allowance will continue to be paid.

Immediate care plans are a type of annuity and as such can provide an income, guaranteed for life, in return for a lump sum payment. The income can be provided on a level basis or it can be index linked. In these times of low inflation, families have to be very careful about whether to index-link returns because the costs might outweigh the benefits. However, if the economy begins to recover, inflation may be a factor again and there could be a shortfall between the income from an annuity and the rising costs of care.

A major advantage of an immediate care plan is that it will be underwritten. The potential resident is given a health assessment to estimate actuarially how long they might live. Because most people in long-term care are elderly and have limited life expectancy due to illness, the rates offered tend to be very generous. The plan will continue to pay out until the individual no longer needs care.

To purchase an immediate care plan, the individual must be assessed as already being in need of care, either in their own home or in a care home.

Unless the plan specifically provides otherwise, when the resident dies there will be no payment from the insurance company and the regular payments will stop. This means that if the individual outlives the actuarial life expectancy, the plan will be very beneficial because the payments received will be more than would be expected from the original lump sum. However, if death is earlier than expected, then the plan is not so helpful.

Overall, immediate care plans help to give peace of mind over paying care home fees during what is often a stressful time. This is an area where tailored advice is essential.

Understanding the inflation figure

Did you know that the Retail Prices Index (RPI) dropped dramatically from its September 2008 peak of 5% pa to -1.2% pa by April 2009? This is a direct result of the 'credit crunch'.

Do not assume, however, that all prices have dropped, because some have increased. The RPI is greatly distorted by the inclusion of mortgage costs that, due to the collapse of interest rates, have become much cheaper.

For many people, especially those without a mortgage, a more relevant figure is the Consumer Prices Index (CPI). This dropped from 5.2% to 2.3% over the same period.

Higher rate relief melts away

When the current set of pension tax rules was introduced in April 2006, one of the most welcome aspects was the scrapping of all the various limits on tax-relievable contributions. In their place came the annual allowance (£245,000 in 2009/10), above which contributions – from any source – are normally subject to a personal tax charge of 40%. This was a genuine simplification and one that potentially cost the government money.

Last November, the Chancellor took the first steps in cutting back on this generosity by announcing that the annual allowance would be frozen for five years after next tax year's increase to £255,000. At the time, this looked like a measure to limit relief at the new 45% tax rate planned for 2011/12.

April's Budget marked a more serious two-stage attack on pension contribution tax relief:

1. From 2011/12, tax relief for pension contributions – from whatever source – will be at basic rate only if your annual income is at least £180,000. If your income is £150,000 or more, then relief will be phased down from higher rate to basic rate at £180,000. The details of this reform are to be subject to consultation.

2. From 22 April 2009, 'anti-forestalling' measures came into effect, designed to prevent you from making large one-off contributions before the 2011/12 restrictions arrive.

Broadly speaking, these interim rules will only affect you in 2009/10 if:

- Your income after normal deductions (other than the personal allowance and pension contributions) is £150,000 or more in the current tax year, 2008/09 or 2007/08;

and

- There is an unscheduled increase in the level of regular (quarterly or more frequently) contributions to your pension arrangements that were in force before 22 April 2009;

and

- Your total pension contributions from all sources during the tax year are more than £20,000 (the special annual allowance).

Where you meet all three criteria, then as a general rule, in 2009/10:

- Any contributions in excess of your total regular contributions will be subject to a 20% tax charge if those regular contributions exceed £20,000.
- Even if your total regular contributions are under £20,000, you will be subject to a 20% tax charge to the extent that your total contributions exceed £20,000.

The precise definitions of income, regular and total pension contributions are extremely complex – the Finance Bill 2009 draft legislation occupies 13 pages and HM Revenue & Custom's technical guide explaining it already runs to 52 pages. However, it can be safely said that you will be unaffected by the anti-forestalling rules in 2009/10 if your gross income for this and the last two tax years is under £170,000 and your income after deductions for any pension contributions you made personally is less than £150,000.

The two-stage attack has been widely criticised, not least because it could mean you have to pay the special allowance charge on annual contributions and some contributions made by your employer. A revenue-hungry Chancellor may also freeze or reduce the income and contribution limits in the future.

If there is one lesson to be drawn from this latest move on pension tax relief, it is the change in value of higher rate tax relief where it remains available. Higher rate relief was simply taken for granted until rumours of its demise started circulating in the days before the Budget. From a post-Budget perspective, 'You don't know what you've got till it's gone'.

Levels and bases of, and reliefs from, taxation are subject to change and their value depends on individual circumstances.

Protecting your business

For both limited companies and partnerships, it is extremely important for a business to protect its assets through insurance (for example, buildings, machinery and company cars). However, many businesses ignore their insurance requirements as far as the individual owners themselves are concerned. This may prove to be a false economy.

Consider the situation where three partners carry on a trading business. That business will have a value and if one of the partners were to die what would be the outcome?

His or her partnership share would normally pass according to the provisions of their will (it is very important for business people to have a will). This means that their share in the partnership would almost certainly be left to one or more members of their family.

The problem is that it would be a rare event if the beneficiary is able to take over the role of the deceased in the partnership. Also, would the other partners find that individual acceptable to them as a fellow partner?

Ideally, the partnership share of the deceased should go to the remaining partners and the monetary value should end up with the family members.

It is unlikely that the surviving partners would be able to afford to buy the partnership share of the deceased without borrowing some or all of the funds required. And what if the new owner did not wish to sell?

There are a couple of ways of approaching this potential problem. One is for all the partners to agree in writing that, should one of them die, the remaining partners have an enforceable option to buy that deceased partner's share from the beneficiaries and indeed that the beneficiaries have an enforceable option to sell it to the remaining partners. To make certain the funds are available when required, each partner should insure their life in trust for the benefit of the other partners.

The importance of undertaking this type of arrangement cannot be over emphasized to ensure the smooth continuation of the business if a partner dies. Shareholding directors of private limited companies are in a similar position as partnerships, and are encouraged to make similar arrangements.

We can help you to make the necessary agreement and discuss the level of life assurance needed. Please call us.

The Financial Services Authority does not regulate the writing of wills and some forms of estate planning.

Capital gains exemption limit rises

The Budget announcement that the capital gains tax (CGT) annual exemption for 2009/10 is £10,100 was very welcome. It is important that those who are in a position to realise capital gains in this tax year consider doing so.

The effect of the 'credit crunch' on equity-based investments is that different sectors of the market may be more successful in showing capital growth in the future. It is therefore a good time to examine existing portfolios and make decisions on whether to adopt a change of strategy.

For married couples or civil partners, the exemption can effectively be doubled because each individual receives their own exemption. To take advantage of this, some investments may have to be transferred between spouses/civil partners so that each has sufficient gains to use their full exemption. Such transfers, although they are 'disposals', can be made without triggering a capital gain as they are deemed to be made on a 'no gain/no loss' basis.

If the increased CGT exemption is not used in this tax year, it is lost forever.

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Trustee investment strategy review

In addition to choosing the type of investment that is income generating or capital building, one of the main principles that trustees have to adhere to in their investment strategy is the effect that taxation will have on their investment choices.

Trustees have to be extremely careful in their investment strategy to avoid any legal action from a beneficiary. There are now three factors to take into account:

- Many trustees are overly invested in interest-bearing assets. The credit crunch has resulted in substantial falls in the interest rates available, severely affecting the beneficiaries of interest in possession trusts. These beneficiaries may have received a higher level of income in the past when interest rates were generally higher. Interest rates could of course recover from their current low level.
- As a corollary to the interest factor, in some areas dividend yields on equity based assets have increased substantially and investment in the right sectors should show an increase in income. Of course, trustees using these assets have to take into account the risk to capital.
- The recent Budget announcements on forthcoming taxation changes are of extreme importance. From 6 April 2010, the tax rate on discretionary and interest in possession trust income over £1,000 will increase from 40% to 50% on non-dividend income and from 32.5% to 42.5% on dividend income. This is a rise in the tax take of 25% on non-dividend income and 30.77% on dividend income. Bear in mind, however, that in an interest in possession trust, distributed income will be assessable on the recipient so some of the tax may be reclaimed if the beneficiary is not a 50% taxpayer.

Trustees should urgently review their investments in light of the above. Not only must the right balance between the sources of income be struck, but the appropriate investment vehicle should be chosen to hold the investments. Depending on the type of trust, different vehicles should be used. For example, with discretionary and interest in possession trusts, there is certainly an investment vehicle available that can reduce the impact of the new tax increases as far as dividend income is concerned.

Levels and bases of, and reliefs from, taxation are subject to change and their value depends on individual circumstances.

Taking retirement income

While the Chancellor has been busy making changes to pension inputs, at the output stage – drawing retirement benefits – there have been several market developments.

Annuity rates have been moving in response to changes in long-term interest rates. The Bank of England is currently buying government bonds as part of its response to the credit crisis and this demand is putting downward pressure on bond returns and hence annuity rates. Economic conditions and a tougher regulatory stance by the Financial Services Authority have also made some insurance companies reassess their appetite for new annuity business.

Away from pure annuities, two companies have withdrawn their more sophisticated retirement income products, while others have worsened terms markedly for new investors.[1] The blame has largely been pinned on highly volatile investment conditions that make it difficult and expensive to offer guarantees.

If you are near the point of turning your pension fund into a retirement income, it is more important than ever that you take advice before acting. Remember, if you make the wrong decision at retirement, you may have to live with it for the rest of your life.

Past performance is not a reliable guide to future returns.

1. The Independent, 26/4/09

Rob Sandwith, Chief Executive

Rosan Helmsley Limited, 3000 Cathedral Hill, Guildford, Surrey GU2 7YB
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