

SUMMER CLIENT NEWSLETTER

THE BUDGET, MKII

This year's Budget has been a strange affair. Its broad shape was set out by Gordon Brown in his swansong 2007 Budget. In it he promised the abolition of the 10% band (other than for savings income), a 2% cut in basic rate tax and higher national insurance contributions for those earning above about £35,000 a year.

Mr Darling's Pre-Budget Report in October 2007 added another raft of changes for this year's two volume Finance Bill: transferable inheritance tax nil rate bands, 18% capital gains tax and new rules for non-domiciled UK residents. While the inheritance tax revision was uncontroversial, CGT and 'non-doms' reforms both prompted some serious re-thinks by the Treasury.

The Budget itself was almost a non-event: in movie terms it felt as if the trailers had been longer and more entertaining than the actual film. Only when the impact of the end of 10% band dawned on MPs did things start to get interesting. Eventually the Chancellor was forced to make an statement on 13 May, just over two months after the Budget proper. It was not the clearest of parliamentary announcements and HMRC had to rush out their own translation as so many experts misinterpreted the Chancellor's words. There were two changes:

Personal Allowance The basic personal allowance was increased by £600 to £6,035. Broadly speaking, if you are a basic rate taxpayer and your earnings are subject to PAYE, you should see a £60 refund in your September pay and then an extra £10 a month for the next six months.

There were no changes to the (higher) age allowances which, ironically, had already been increased substantially to compensate for the loss of the 10% band. There was also no change to the starting point for National Insurance Contributions (NICs), which has been linked to the personal allowance for the past few years.

Higher Rate Tax Threshold The Chancellor said that he was 'reducing the threshold at which an individual starts to pay tax at the higher rate by £600'. Tax experts assumed that he meant he was cutting the basic rate band from the £36,000 announced in March to £35,400, but as the HMRC statement showed they were wrong. The Chancellor has cut the basic rate band by £1,200 to £34,800: his £600 figure allowed for the increase in the personal allowance.

The net result is these two changes is that if you are a higher rate taxpayer, you will be no better off (and no worse off – see below). If your income is at the top of the basic rate band you will not receive the full benefit of the increased personal allowance.

One side effect of shrinking the basic rate band has been to increase the number of higher rate taxpayers by an estimated 350,000, bringing the 2008/09 total to just shy of 4 million.

No Win for Higher Rate Taxpayers

Joan is a higher rate taxpayer with earnings of £45,000 a year. She sees no benefit from the May tax changes: what she gains through the higher personal allowance she loses by paying more higher rate tax.

	Budget 2008/09 Mk I		Budget 2008/09 Mk II	
	£	£	£	£
Earnings	45,000		45,000	
Personal Allowance	<u>5,435</u>		<u>6,035</u>	
Taxable income	39,565		38,965	
Basic rate tax	36,000 @ 20%	7,200	34,800 @ 20%	6,960
Higher rate tax	3,565 @ 40%	<u>1,426</u>	4,165 @ 40%	<u>1,666</u>
Total Tax		<u>8,626</u>		<u>8,626</u>

ACTION

If you or your partner aims to cover the personal allowance with investment income, you may need to find another £600. However, if you employ your partner or spouse, you should not increase their salary beyond £5,435 as this would bring NICs into play.

Check whether you have become one of the new higher rate taxpayers. If so, there is one piece of good news – 40% tax relief on some of your pension contributions.

The best way to save tax is through proper planning. Don't rely on a fickle Chancellor, call us today for a tax review.

AN ILL WIND...

The Credit Crunch is becoming an enduring feature in the investment landscape. It is now more than nine months since Northern Rock became Northern Wreck and well over a year since the first subprime tremours were felt in the United States. One consequence that has gone largely unnoticed is that ordinary annuity rates have been rising and are now at a five year high. This is because of the increase in yields on corporate bonds, which life companies use as the underlying investments for annuities.

The improvement is significant, even if it does not make up for the long term decline from the levels of the early 1990s. For example, annuity rates today for a man aged 65 are about 12% higher than they were in 2006.

Does this mean now is the time to turn your pension fund into an annuity?

Alas, there is no easy answer to that question:

- All other things being equal (which they probably won't be) annuity rates are in long term decline simply because we are all living longer. Today's 65 year old man has a much better chance of reaching age 90 than their counterpart from the 1980s.
- In the short term, the path of corporate bond yields is hard to predict. One school of thought says bond yields will continue to rise – and with them annuity rates – because the demon of inflation has returned to haunt us. On the other hand there are those who expect a fall in bond and annuity rates soon as a recession takes hold and/or the credit crunch unwinds.

To complicate matters further, there are several other income options to consider instead of buying a traditional annuity. In practice an annuity is what most people with a personal pension fund choose, but then the average pension fund is under £25,000. The more sophisticated (and higher risk) income options, such as income drawdown, are unsuitable for such modest sums.

If you are thinking about buying an annuity, you should *never* simply accept the rate offered by your pension provider. The annuity market is unusual in that some pension providers – including several big names – quote rates that they know to be uncompetitive. Many will also ignore your state of health, which is an increasingly important factor now that more companies offer 'enhanced' rates for conditions such as high blood pressure or diabetes.

ACTION

Do not let annuity rates alone determine whether you should retire now – there are many more factors to consider. If you do decide the time is right to start drawing an income, your next step is to take advice. Make the wrong decision and you could pay for the error all the way through to your nineties.

Call us today for the latest annuity rates and an explanation of your pension income alternatives.

THE END OF PEPS

Personal Equity Plans (PEPs) first appeared on 1 January 1987. They nearly disappeared a year or so later, such was the lack of interest in what was then a highly complex share-based plan. Several changes were made over the next few years, which helped revive interest, although it was not until 1995 that it became possible to invest up to the then maximum (£6,000 for general PEPs) solely in unit trusts.

In April 1999, after a controversial consultation process which originally suggested capping total investments, PEPs were replaced by Individual Savings Accounts (ISAs). In many respects ISAs were simply PEPs under another name. While PEPs

could no longer accept new investments, they remained in being and their tax exemptions were unchanged.

From 1999 onwards the rules for PEPs were gradually changed towards those which applied to stocks and shares ISAs, so it became inevitable that the two would eventually merge. This happened on 6 April 2008, when the PEP regulations came to an end and all PEPs became ISAs.

In practice you are unlikely to notice any difference between the old PEP and the new ISA. There is one minor tax disadvantage stemming from the change – interest on cash is now taxed at 20%, whereas within a PEP it was tax-free. However, this would generally only matter if you are a PEP investor who has a self-select share-based plan and regularly hold cash between trades.

Some providers have merged PEP and ISA accounts automatically, while others have kept them separate, at least for the time being. ISAs, whether original or new-born PEPs, continue to offer valuable tax advantages, particularly to higher rate taxpayers:

- Interest from fixed interest securities is free of UK income tax.
- Dividends suffer no additional tax, although since April 2004 it has not been possible to reclaim 10% dividend tax credits. The freedom from higher rate tax has become increasingly important as the average dividend yield for UK shares has risen – it is now (early June 2008) 3.8%.
- All gains are free of capital gains tax. This is more important than you might imagine. While the *rate* of capital gains tax for investments has fallen, the loss of taper relief means there are larger net gains to tax. HMRC expect the *number* of CGT payers to increase by over a third in this tax year as a result.
- There is nothing to report on your tax return. For the significance of this see 'New Tax Paperwork' below.

ISA Tax Savings

If you are a higher rate tax taxpayer, an ISA can boost you net income by up to 67%.

Investment	Income Outside ISA	Income Inside ISA	ISA Advantage
£10,000 Fixed Interest Fund 5.6% yield	£336	£560	+66.7%
£10,000 UK Equity Income Fund 4.0% yield	£300	£400	+33.3%

Yields based on Trustnet IMA sector averages for UK Other Bond and UK Equity Income as at 5 June 2008.

ACTION

The consolidation of PEPs and ISAs marks a good time to review the two together and the combined role they play in your investment portfolio. Some former PEP investments could now be more than 20 years old – are you sure they are still the right ones for you in 2008?

Call us for a review of your PEPs and ISAs and information about consolidating them all into a single plan.

A SENSIBLE SACRIFICE

Salary sacrifice may not sound immediately attractive, but it has become an increasingly popular way to boost pension contributions. Its appeal has been boosted by the recent rise to in the ceiling for full rate employee national insurance contributions (NICs). At just over £40,000 a year, the NICs upper earnings limit is now very close to the (revised!) starting point for higher rate tax.

If you are an employee, salary sacrifice works in the following way:

- You agree a reduction in your future salary with your employer. This will mean less pay, but also less income tax and less NICs.
- In return for the reduction in your salary, your employer makes a contribution to your pension. As the employer will save NICs because of your pay reduction, they may increase the pension contribution by up to 12.8% above the amount of salary you have sacrificed.

An Instant Increase

Joan earns £35,000 a year and pays £200 a month net (£250 gross before 20% tax relief) into a personal pension. She agrees with her employer, who does not have a pension scheme, to make a salary sacrifice of £290 a month.

Her net monthly income falls by:

	£
Gross pay	290.00
NICs @ 11%	(31.90)
Income tax @ 20%	<u>(58.00)</u>
Net pay	<u>200.10</u>

Her employer puts all their pay and NICs savings to Joan's pension as a contribution:

	£
Gross pay	290.00
NICs @ 12.8%	<u>37.12</u>
Total contribution	<u>327.12</u>

Joan is 10p a month poorer (she saves the £200 that would have gone to her pension), but her gross pension contribution has increased by £77.12 (30.8%).

You can apply the same principle to sacrificing bonuses or other one-off payments. However, salary sacrifice is not suitable for everyone, as it can have drawbacks. For instance, in the example above Joan's lowered salary means that she will accrue less State Second Pension.

ACTION

If you make contributions to a pension scheme, whether or not it is run by your employer, find out if salary sacrifice is an option. In larger employers your starting point will usually be the human resources department.

If your employer does offer salary sacrifice, talk to us about the benefits and pitfalls of choosing this option. Your employer will generally not give you advice specific to your own personal circumstances – we can.

A SECOND COMPANY CAR?

Back in the mid-1980s, when the top rate of income tax was 60%, some higher earning employees found it made sense to have *two* company cars. The idea did not last long before the then Chancellor, Nigel Lawson, cut higher rate tax to 40% and sharply increased the taxable value of cars.

Wind forward to 2008 and once again, a second company car could make sense. This time the car has to be fuel efficient, with a petrol engine giving CO₂ emissions of no more than 120g/km. If the car meets that threshold, the taxable benefit is only 10% of the list price. So if you are a higher rate taxpayer, a £10,000 car would cost you only £400 in tax.

ACTION

If your spouse/partner/son/daughter needs a car, think about swapping some of your salary for a new car. You will need to do some number crunching before you decide, but the new Fiat 500 could prove a more tempting option for everyone than the second hand Ford Fiesta.

NEW TAX PAPERWORK

If the tax return that you received in April is still sitting unopened on your mantelpiece, you could be in for a surprise. HMRC have completely revised the main individual tax return form (SA100) so that it now covers just six pages. They have achieved this shrinkage in part by inventing another form (Additional Information SA101) which picks up some of the more esoteric details that used to be on the main return.

There are a number of other changes. For example, if you have to report capital gains, you must now supply your calculations for each gain.

ACTION

You cannot rely on last year's return to guide you through this year's – the numbering has changed. If you do not employ an accountant, start looking at the form now. Unless you file by internet, your return must now reach HMRC by 31 October 2008.

For tax assistance on investments we have arranged, please call us (but not on 30 October!).

Past performance is not a reliable guide to the future. The value of investments can go down as well as up. The value of tax reliefs depend upon individual circumstances and tax rules may change. The FSA does not regulate tax advice. This newsletter is provided strictly for general consideration only and is based on our understanding of law and HM Revenue & Customs practice as at June 2008 and the contents of the Finance Bill 2008, which could be subject to change. No action must be taken or refrained from based on its contents alone. Accordingly no responsibility can be assumed for any loss occasioned in connection with the content hereof and any such action or inaction. Professional advice is necessary for every case.