

AUTUMN CLIENT NEWSLETTER

INCOME TAX AND NATIONAL INSURANCE CONTRIBUTION REFORMS

In November's Pre-Budget Report, Alistair Darling took a leaf out of his predecessor's book and announced a range of income tax and national insurance contribution (NIC) changes, staggered to take effect over the coming years:

(i) 2009/10

The Chancellor has given up on his May suggestion that the out-of-Budget increase in the personal allowance (and corresponding reduction in the higher rate threshold) were a temporary fix to the problems created by the 10% band changes. For next tax year the personal allowance rises by 7.3% - above the automatic statutory indexation – to £6,475. Curiously, the other main allowances were only increased by the required 5%.

The starting point for higher rate tax will rise by £800 more than statutorily required to £37,400 of taxable income. However, the principle – but not the final number – had already been announced by Gordon Brown in his (final) 2007 Budget.

The increase in the higher rate threshold was accompanied by implementation another 2007 Budget announcement. This sees the upper earnings limit for main rate NICs aligned with the level of income at which higher rate tax theoretically begins to be paid (£844 a week in 2009/10). Thus some of next tax year's higher rate tax savings will be clawed back through higher NICs.

The impact of the income tax and NIC revisions is shown in the table below. The biggest winners are those with earnings of at least £43,875.

Earnings £	2008/09		2009/10		Overall Benefit* £
	Income Tax £	NICs £	Income Tax £	NICs £	
10,000	793	502	705	471	+ 119
15,000	1,793	1,052	1,705	1,021	+ 119
20,000	2,793	1,602	2,705	1,571	+ 119
25,000	3,793	2,152	3,705	2,121	+ 119
30,000	4,793	2,702	4,705	2,671	+ 119
35,000	5,793	3,252	5,705	3,221	+ 119
40,000	6,793	3,802	6,705	3,771	+ 119
45,000	8,626	3,856	7,930	4,209	+ 343
50,000	10,626	3,906	9,930	4,259	+ 343

* Based on an employee under age 65 with a single personal allowance who is contracted in to State Second Pension. Tax credits are ignored.

(ii) 2010/11

Mr Darling expects the economy to be well into recovery mode by 2010/11, so this is when the first of the tax increases begin. The personal allowance will be reduced in two stages:

- If you have gross income of over £100,000, but less than £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. This is likely to mean that your personal allowance will be halved (to about £3,300) if your income is between about £106,600 and £140,000.
- If you have gross income of over £140,000, your personal allowance is further reduced by £1 for each £2 of income over £140,000. This is likely to mean that you will have no personal allowance if your income more than about £146,600. The net effect would be that you would pay approximately an extra £2,650 in tax.

Both phased reductions create a band of income about £6,600 wide where the effective marginal tax rate is 60%.

(iii) 2011/12

This tax year sees Mr Darling plan a repeat of the trick used by his predecessor in 2003. Rather than explicitly increase all income tax rates, the Chancellor plans to raise all NIC rates for employees, employers and the self employed by 0.5%. For example, if you are an employee contracted in to the State Second Pension Scheme, your NIC rates will become 11.5% and 1.5% against 11% and 1% now. Once again high earners come off worst because they will have a large slice of income on which their NIC bill rises by a half (thanks to a rate increase from 1% to 1.5%).

Very high earners will also pay more income tax, as 2011/12 marks the introduction of a new 45% top tax rate for taxable income of over £150,000. The same rate will also apply to all trusts which accumulate income, regardless of their income level. For dividends, there will be a corresponding new top rate of 37.5%.

ACTION

The Chancellor's planned income and NICs reforms – which might not survive the next general election – potentially have important repercussions for tax planning. What looked a sensible idea before the Pre-Budget Report may now be the wrong approach.

Call us today to fix a date for a review your tax planning, to cover both the approaching tax year end and for Mr Darling's longer term ideas.

A PENSION RETHINK MAY BE NEEDED – RAPIDLY!

The Chancellor's Pre-Budget Report contained two unexpected announcements about the taxation of pensions. For five years from 2011/12 the Chancellor plans to freeze:

- *The lifetime allowance*, which effectively sets the normal tax-efficient maximum value of pension plan benefits; and
- *The annual allowance*, which usually sets the maximum tax-efficient contribution (or increase in the value of pension benefits) in a single tax year.

The lifetime allowance started at £1.5m in April 2006 and will reach its freezing point of £1.8m in April 2010. Similarly the annual allowance began at £215,000 and will plateau at £255,000. It had generally been thought that the lifetime allowance would rise each year for the five years after 2010/11, at least to reflect inflation. The annual allowance has been increasing at £10,000 a year and there had been no indications that the pattern would not continue.

The Chancellor's move sits alongside future income tax and NIC increases for high earners. The freeze was probably at least partly prompted by a desire to limit the scope for pension contributions with 45% income tax relief from 2011/12. However, its impact is much wider, as the example below shows.

Frozen Out?

On 5 April 2006, Helen had a self invested personal pension (SIPP) with a value of £1m, which was invested in a variety of equity and property funds. Just over a year later, when talk about the credit crunch started to grab the headlines, Helen switched all her SIPP into cash funds, where it has remained since. The SIPP is now worth £1.3m.

In May 2006, Helen had discussed with her adviser whether she should elect for 'transitional protection' to protect her SIPP from a tax charge if its value grew to above the level of the lifetime allowance. Both agreed that there was very little likelihood of needing such protection because:

- Helen was not going to make further contributions;
- Her fund would have to grow by 50% to match the then lifetime allowance of £1.5m; and
- The lifetime allowance would be £1.8m by 2010 and was expected to grow each year thereafter.

Helen and her adviser are now having a rapid rethink. Helen's planned retirement date is December 2015, when the (frozen) lifetime allowance will be £1.8m. If the value of Helen's SIPP grows by more than about 4.8% a year, she will be facing a lifetime allowance charge of up to 55% on part of her funds.

ACTION

The freezing of the lifetime and annual allowances means that your retirement planning should be reviewed. You may need to elect for transitional protection – a complex process – before the 5 April 2009 deadline. Alternatively it might be wise to alter the timing of contributions or even when you start to draw benefits.

Call us today for a Pre-Budget Report reassessment of your retirement planning.

NOT VERY INTERESTING

At the beginning of December 2007, bank base rate was 5.75%. Twelve months later it had almost halved to 3%, with further cuts widely anticipated. There are even suggestions that the rate could drop below 2%, the lowest ever level since the creation of the Bank of England in 1694. If you think that impossible, then look across the Atlantic where the US equivalent is already 1%.

If you are a borrower and *if* your lender passes through the interest cuts in full, ultra low base rates are good news. On the other hand, if you rely on deposit interest to supplement your income, a sharp drop in base rates is unwelcome. To make matters worse, many institutions have added to the fall in income by reducing their deposit rates by more than the decline in base rates. The end result is that for the same size of deposit, the monthly interest you receive in January 2009 could be less than half that of January 2008.

While short term interest rates have been falling, elsewhere income returns have been rising (see box).

UK Shares A corollary of the sharp fall in share prices has been a rise in dividend yields. As at 25 November the average yield on UK shares was 5.6%. There are two important points to note about this figure:

- The yield is quoted net of 10% tax. If you are a higher rate taxpayer, you have an additional tax liability equal to a quarter of the net dividend. If you are a basic rate taxpayer, you have no tax to pay – 5.6% is what you will receive. Non-taxpayers cannot reclaim the 10% tax, so also receive 5.6%.
- The yield quoted, like those found in most newspapers, is historic. This means it is based on dividends paid over the last 12 months. In the current difficult economic conditions there is no certainty that dividend payments will stay the same for the next year. The likelihood is they will fall, if only because most of the banks will not be paying any dividends in 2009.

Overseas shares Just as the yield on UK shares has increased, so too has the income available from overseas equities. The absolute level is normally lower than the UK, but the average yield on foreign shares is now around 4.1%.

Corporate Bonds Many fixed interest securities, other than government bonds, have fallen in value because of the concerns surrounding the credit crunch. Once again, the fall in value means higher income yields: a typical increase has been over 2% in the last 12 months. As a general rule, the higher the yield, the greater is the risk that the borrower will default – so there are some extremely high figures around for some companies' bonds.

The higher income from non-deposit investments comes with a potential risk which has been all too obvious in 2008: whereas your capital is secure in a deposit account (at least up to the £50,000 compensation limit), the value of shares and corporate bonds can go down as well as up.

ACTION

If falling interest income is a concern, then switching money to funds that invest in shares or corporate bonds could be worth considering as a way to revive your income. However, you should not make such a move without taking advice.

For an analysis of the potential risks and rewards of moving away from low-paying deposits, please contact us.

REVISED INTESTACY RULES

What happens if you die without a valid will? The answer is not always what you would expect – or what you would want.

The rules of intestacy come into play when there is no will and vary between the different constituent countries of the United Kingdom (although England and Wales share the same law). The current English rules (summarised in the box below) were the subject of a partial review which started in June 2005, eventually producing a government announcement at the end of August 2008.

Main Intestacy Rules for England and Wales

If you die leaving:

- 1. A spouse or civil partner who survives you by 28 days, but no children, parents, brothers, sisters, nephews or nieces**
Your spouse or civil partner takes everything outright.
- 2. A spouse or civil partner who survives you by 28 days and children**
Your spouse or civil partner takes personal chattels (eg jewellery),
plus £125,000 outright,
plus a life interest (ie right to income only) from half of the residue.

Children take half the residue on reaching 18 or marrying below that age,
plus half the residue on the death of the surviving spouse or civil partner.

- 3. A spouse or civil partner who survives you by 28 days, no children, but parents, brothers, sisters, nephews or nieces**
Your spouse or civil partner takes personal chattels (eg jewellery),
plus £200,000 outright,
plus half of the residue outright.

Parents, failing whom brothers and sisters (nephews and nieces step into their parent's shoes if the parent is dead) take half the residue.

- 4. No spouse or civil partner who survives you by 28 days**
Everything is taken by children, but if none:
parents, but if none:
brothers and sisters of the whole blood (nephews and nieces step into their parent's shoes if the parent is dead) but if none:
brothers and sisters of the half blood (nephews and nieces step into their parent's shoes if the parent is dead) but if none:
grandparents, but if none:
uncles and aunts of the whole blood (cousins step into their parent's shoes), but if none:
uncles and aunts of the half blood, but if none:
The Crown

Note: Children includes adopted children and illegitimate children

From 1 February 2009, the lump sum payable to a surviving spouse or civil partner where you leave children will rise from £125,000 to £250,000. If there are no children, but surviving parents, brothers, sisters, nephews or nieces, the lump sum to your surviving spouse or civil partner rises from £200,000 to £450,000.

The increases to the lump sums are overdue. The last revision was made in 1993, since when the average UK house value has virtually trebled (despite recent falls). More changes are on the way – the Law Commission is now undertaking a broad review of intestacy and family provision, with draft legislation due ‘in late 2011’.

Whatever eventually emerges, the rules of intestacy will never be anything other than second best to a properly drafted, up to date will. Intestacy rules take no account of inheritance tax and implicitly assume anybody aged 18 is financially responsible.

ACTION

If you do not have a will, then make one. And if you do have a will, make sure it is up to date. If your will is much more than a year old, it may need amending to take account of significant inheritance tax changes announced in *last* year’s Pre-Budget Report.

A will is the cornerstone of much inheritance tax planning, so if you amend your will, make sure you talk through the consequences with us.

INVESTOR PROTECTION – WHERE ARE WE NOW?

2008 has seen the issue of investor compensation come to the fore, with the demise of several high profile deposit-taking institutions.

In October, as the Icelandic banks were melting, the Financial Services Compensation Scheme (FSCS) cover for deposits with UK banks was raised to 100% of the first £50,000. However, the Chancellor chose to give *individual* depositors unlimited protection for their savings in Bradford & Bingley, Icesave, Heritage and Kaupthing Edge. Mr Darling’s generosity was probably prompted by concerns about creating a run on the UK banking system, which as we now know, the Services Authority (FSA) believed to be in serious need of fresh capital. However, it would be wrong to assume that the Treasury will always step into the breach to rescue wealthy depositors.

With one important new exception, the improved £50,000 limit still applies per *banking license*, not per institution. So a bank that uses one banking license to cover several deposit-taking brands (eg Santander with Abbey National, Cahoot, Bradford & Bingley and Asda) only offers you £50,000 *total* cover. This one license restriction is becoming more of an issue as banks merge but retain their old names.

In late November the FSA announced a *temporary* exception when building societies merge. If the merged societies continue to operate under their former names, then until September 2009, the £50,000 limit will apply separately to pre-merger accounts.

There have been no changes to other FSCS compensation limits or rules (see table).

Product	Maximum compensation
Deposit accounts	£50,000 per person per licensed bank
Investments (eg unit trusts)	£48,000 per person per investment firm: 100% of first £30,000 and 90% of next £20,000
Long term insurance (including investment bonds)	No monetary limit 100% of first £2,000 plus 90% of balance of claim

Two points about the FSCS are worth remembering:

- FSCS compensation only covers businesses authorised by the FSA. If you invest offshore, you may have a different level of protection or none at all. While the Chancellor did step in to rescue Bradford & Bingley's Isle of Man depositors, that was the exception that proves the rule.
- The FSCS provides covers if an FSA authorised business becomes unable to pay claims against it. It does not offer compensation for poorly performing or failed investments. The line between the two may not be immediately clear, but it is very important one.

ACTION

For deposits, it still makes sense to limit investment with any one banking license holder to £50,000, unless you are dealing with National Savings & Investments or Northern Rock. These both offer 100% security, but neither pays particularly competitive rates.

If you have any concerns about the security of any investments we have arranged for you, please do not hesitate to talk to us.

HOW MUCH WILL YOU RETIRE ON?

In the Pre-Budget Report, the government announced the new rates for the basic state pension from April 2009. These will increase by 5% - in line with the rise in the Retail Prices Index to September 2008 - making the single person's pension £95.25 per week and a married couple's pension £152.30 per week.

The government is committed to bringing basic state pension increases back in line with earnings inflation, although this will not happen until 2012 at the earliest. Ironically on this occasion an earnings-linked increase would have produced a smaller number.

ACTION

The basic state pension remains inadequate, a fact the government has acknowledged with the introduction of Pension Credit. Unless you want a subsistence retirement, you must have other pension provision.

Past performance is not a reliable guide to the future. The value of investments and the income from them 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 November 2008 and the contents of the 2008 Pre-Budget Report. 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.