Bulletin

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MFS

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Focus on year end planning

Now that the New Year festivities are over, it is once again time to consider your year end tax planning. On this occasion, the spring Budget is likely to be less of an obstacle to planning than usual, because last November's Pre-Budget Report (PBR) was more like a Budget in its own right. For instance, the PBR announcements have altered some traditional tax year end strategies. Your 2008/09 checklist should include:

Pension contributions

If you make a pension contribution before 6 April (a Monday in 2009), any tax relief you receive will be based on your income in the current tax year. If the recession means that your income is going to be the same or lower in 2009/10, you could be in a position where you would receive 40% tax relief on a pension contribution made in 2008/09 but only 20% in 2009/10. The likelihood of this situation happening has been increased by the changes to allowances and the higher rate threshold announced in the PBR.

Contracting out

Now is the time to review whether to become a member of the state second pension scheme (S2P) if you currently opt out (or 'contract out') using a personal pension.

The national insurance contribution rebates set for contracting out are far from generous and capped at the age of just 43. If you are aged 43 or above, contracting out will only make sense in limited circumstances. In any event, it is important to seek specific information based on your own particular situation.

Inheritance tax (IHT)

You should aim to use all of your annual inheritance tax exemptions, of which the £3,000 annual exemption is generally the most useful. Your 2008/09 exemption can be carried forward only to the next tax year (2009/10) and then can only be used after the 2009/10 exemption has been fully used. If you and your partner have not made any gifts since 5 April 2007, you could now jointly give away £12,000 free of IHT. Make sure you seek individual advice.

Individual Savings Accounts (ISAs)

The maximum you can invest in an ISA each tax year is now £7,200, of which no more than £3,600 can be in a cash ISA. Your ISA allowance cannot be carried forward, so if you do not use it, you lose it.

The Financial Services Authority does not regulate taxation and trust advice.

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Moving up on interest

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] The rate could fall further – the US already has virtually 0% rates.

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. 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 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).

Corporate bond funds

While short-term interest rates have been falling, the opposite has been happening to the yields available from many fixed interest securities. 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 because they are normally based on the last year's payments. In 2009, there will be dividend cuts, 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*

Think ahead on income tax

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 to £6,475 and the basic rate limit will increase from £34,800 to £37,400. These improvements are countered by a substantial increase in the upper level at which full rate NICs are paid – from £40,040 to £43,875.

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 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 around £146,600.

These phased reductions create two bands of income about £6,600 wide, where the effective marginal tax rate is 60%.

2011/12

In this tax year:

- NIC rates for employees, employers and the self-employed will rise by 0.5%.
- There will be a new 45% income tax rate (37.5% for dividends) for taxable income above £150,000.

Some changes are not due to take effect until after the next general election. However, such is the hole in the public finances that 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 are taking maximum advantage of independent taxation.
- If you could be caught by the personal allowances restriction, review whether it will be possible to avoid the 60% marginal rate band.
- If paying 45% income tax from 2011/12 is a possibility, think about bringing forward income into an earlier tax year.
- Capital gains, taxed at 18%, might be preferable to 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.

Another round on pensions

Pension Acts have become rather like London buses recently. 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 makes three important changes:

Personal accounts

The personal account is the latest government initiative to encourage private pension provision. If you are an employer, 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 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 set, although the expectation is that it will be April 2012.

If you are a member of a final salary (defined benefit) contracted out scheme, the change will not affect you.

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.

Did you know that the Pre-Budget Report announced that two important pension allowances – the lifetime allowance and the annual allowance – will be frozen for five years from April 2011?

It had been expected that both would rise broadly in line with inflation. The move is aimed at limiting the use of pension contributions as an escape route from 45% income tax, but it has much wider implications. If you are due to start drawing your pension benefits after 2011, you should consider revisiting your retirement strategy.

Income shifting legislation delayed

If you are a shareholder-director in your company with your spouse or civil partner, you might be thinking about declaring dividends at this time of year and taking advantage of certain tax-saving benefits.

Arrangements involving the gifting or purchase of shares in businesses where one shareholder, often a spouse or civil partner, is taxed at a lower rate than the prime income generator, are called 'income shifting'. This was made possible by the introduction of independent taxation in the early 1990s.

The 'Arctic systems' case in 2007, officially *Jones v Garnett*, threatened to make such arrangements unlawful. Mr and Mrs Jones were shareholders in a small private limited trading company that paid part of its profits out as dividends to try to reduce the impact of income tax on moneys extracted from the company.

Unexpected outcome

The then Inland Revenue challenged that, for one year in which the Jones' both took salaries of around £20,000 and the balance of the income they needed as dividends, Mr Jones, as the prime income generator, 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' eventual ruling in favour of the Jones' in July 2007 dismayed the government and HM Revenue & Customs (HMRC). HMRC had hoped to be able to assess other such shareholders in a similar way. Immediately after the case, the government vowed to bring in legislation to close this loophole in the tax system.

Hold on legislation

New rules were expected to be in place, effective from tax year 2009/10. The legislation has now 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.

However, it may 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*

Back to work with new support allowance

Do you know what the 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.

Review your protection

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.

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.

There are similar issues 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 that your employees' total level of replacement income has effectively been cut.

More change for the Financial 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 account holders, 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.

Trustees' tax rate going up

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

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 extremely 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 and trust advice.

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