financial focus

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Getting to grips with inflation

Inflation rates are set to fall, but the past damage remains.

What is happening to inflation?

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Annual inflation reached 5.6% last September, as measured by the retail prices index (RPI). That was its highest level since June 1991. Inflation has since started to drift back, with RPI down to 4.8% in December 2011, and the general expectation is that the fall will continue well into this year.

The Chancellor's financial watchdog, the Office for Budgetary Responsibility (OBR), calculates that annual RPI inflation will be 3.3% by the end of 2012 and 2.9% in the following year. The Bank of England is similarly optimistic that inflation will drop, although the Bank's inflation forecasting record in recent years has been far from perfect.

Three letters sum up one of the main reasons why there is a widespread consensus that inflation will fall: VAT. In January 2011, the standard rate of VAT increased from 17.5% to 20%, but there was no such increase at the start of this year. Thus 2012 has started without tax-driven price increases, so inflation should be lower.

Whether or not the economists are right about the future path of inflation, there is no doubting about its past. Over the last two years (to December 2011), the RPI has risen by just under 10%. In other words, £1 in December 2009 has the buying power of 91p today.

Such a level of price increases means that you should consider reviewing your financial plans now, if you have not done so in the last 12 months. For example, your life cover should normally be adjusted in line with inflation or its real value will fall. In round numbers £100,000 cover in place two years ago needs to be £110,000 today, just to retain the same purchasing power.

There are similar considerations for your income protection cover. If £30,000 a year was adequate cover for you at Christmas 2009, then today your cover should be £33,000. Regular savings feel the draft from inflation, too. For example, if you started setting aside £250 a month at the start of 2007, to maintain the real value of that investment, you should now be saving at the rate of £295 a month.

Inflation will also mean that your retirement planning could need a reassessment. The erosion of value caused by recent inflation will still be there when you retire, unless you make appropriate adjustments. That could mean higher contributions, a later retirement date or a combination of the two.

The value of tax reliefs depends on your individual circumstances. Tax and pensions laws can change.

In this issue: Tax year-end approaches • The pensions revolution continues • Investing for growth • Company car tax changes • Autumn Statement surprises • Time to revisit commercial property? • Partnership and shareholder protection • Driving up your savings • Daring to say the B word

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'...it could be a wise precaution to make any planned 2011/12 pension contributions before Budget Day.'

The tax year-end approaches

With the prospect of tax cuts increasingly distant, year-end tax planning has become more relevant than ever in cutting your contribution to the Exchequer.

Chancellor George Osborne's spring Budget will have plenty of announcements, but probably little that is unexpected. In any event, his past two Budgets have introduced a wide range of tax changes, some of which have yet to take full effect. These changes mean that the checklist for year-end tax planning in 2011/12 is not the same as in previous years.

There are a number of things you need to consider before the Chancellor rises to speak this coming March.

Pensions provision

The start of the new tax year on 6 April will see several important revisions to pension law taking effect, as we explain in 'The pensions revolution continues' on page 4. However, many changes took effect last April and some are now part of year-end planning. For example, the reduced £50,000 annual allowance and the new carry forward rules both apply in 2011/12 and could impact on your year-end pension contributions.

In particular, the carry forward provisions have created a deadline of Thursday 5 April 2012 for using up to £50,000 of unused allowance from 2008/09. The calculations involved are complex, so planning is best started as soon as possible.

Rumours that the Chancellor would end higher rate (and additional rate) tax relief on pension contributions re-emerged in the run up to the Autumn Statement. Just in case Mr Osborne is unable to resist the £12 billion a year in extra income this time around, it could be a wise precaution to make any planned 2011/12 pension contributions before Budget Day (21 March).

Tax saving with individual savings accounts (ISAs)

Your 2011/12 ISA contribution limit is £10,680, rising to £11,280 from 6 April 2012. The Junior ISA, introduced last November, has a limit of £3,600 which will not change in April. Maximising your ISA investment will usually make sense because:

- Dividends and income from fixed-interest securities held within a stocks and shares ISA are free of personal UK tax, although you cannot reclaim dividend tax credits.
- Interest earned on deposits in a cash ISA are also UK tax-free. However, the returns on offer reflect the fact that the base rate shows very few signs of moving above 0.5%.
- Gains made within ISAs are free of capital gains tax (CGT).
- There is nothing to report on your tax return.

Your CGT annual exemption

While 2011 was not a profitable year for many major stock markets, if you have held shares or share-based investments for several years you may well have unrealised gains. It could be advisable to realise some of these gains before 6 April. In 2011/12 you can crystallise gains of up to £10,600 without any liability to CGT. The exemption cannot be carried forward, so you lose it if you do not use it.

Inheritance tax (IHT)

The IHT nil rate band of £325,000 is now in the middle of a freeze that will last until April 2015. This means it is all the more important to use your annual IHT exemptions.

The main £3,000 annual exemption can be carried forward, but only to the next tax year (2012/13), and then can only be claimed once the 2012/13 exemption has itself been used up. If you and your partner have not made any gifts since 6 April 2010, you could now jointly give away £12,000 free of IHT.

The value of tax reliefs depends on your individual circumstances. Tax laws can change. The Financial Services Authority does not regulate some forms of inheritance tax planning.

Low Value Consignment Relief (LVCR) may sound very technical, but did you know that if you have ever bought CDs, DVDs, printer cartridges or even health food supplements from the Channel Islands, LVCR has probably saved you VAT? LVCR currently means imported goods worth less than £15 escape VAT, but in November the Treasury announced it would be scrapping LVCR from 1 April 2012 for goods sent from the Channel Islands. That will affect not just the Channel Island websites, such as Play.com, but also many High Street names that sell CDs and DVDs online via the Channel Islands. So if your music and movie collection needs additions, act soon!

The pensions revolution continues

The world of pensions continues to change rapidly, with more changes from April 2012 and further announcements from the Government.

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The start of the new tax year on 6 April marks several important changes to pensions.

Contracting out If you are currently contracted out of the state second pension (S2P) through a personal pension or a money purchase occupational scheme, your contracting out will end automatically on 5 April 2012. The funds built up in your private pension arrangement will remain, but from 6 April you will start to accrue S2P. As with other state pensions, S2P is not payable before your state pension age (SPA) – see below – and normally has no lump sum element.

National insurance contributions (NICs) If you are contracted out via your employer's occupational scheme, then your (and your employer's) NICs bill is set to rise from April. For final salary schemes, the employee NICs rebate for contracting out will fall from 1.6% to 1.4%. For money purchase schemes, the rebate will disappear completely because contracting out will have ended. If you have a personal pension, your NICs rates will not change.

Lifetime allowance The standard lifetime allowance, which normally sets the maximum tax-efficient value of pension benefits, will fall from £1.8 million to £1.5 million. If you have existing primary or enhanced protection, the reduction will have little, if any effect. However, if you have no protection, then you may need to consider the option of claiming fixed protection, which was introduced last year.

Broadly speaking, fixed protection allows you to keep the £1.8 million lifetime allowance, but only if no further contributions are made to your pension arrangements and you accrue no more benefits. A claim for fixed protection must be made by 5 April 2012. If you think it might be relevant to you, please contact us as soon as possible.

Two other aspects of pensions were the subject of announcements late last year, but their impact will be longer term.

State pension age (SPA) The phasing of the increase in SPA to 66 was changed in a last-minute amendment to what was then the Pensions Bill and is now the Pensions Act 2011. The adjustment means that the maximum increase in SPA any woman will face in 2020 is 18 months, rather than the 24 months previously proposed.
Some men will also see their SPA brought forward marginally from the original plans. You will only be affected by these adjustments if you were born between 6 April 1954 and 5 October 1954.

Shortly after the Pensions Act had been passed the Chancellor, George Osborne, announced in his Autumn Statement that the timing of the next increase in SPA (to 67) would be accelerated. Instead of taking place between April 2034 and April 2036, the increase will now be introduced eight years earlier, between April 2026 and April 2028.

Mr Osborne also said that future increases to SPA would 'be based on demographic evidence', which suggests the currently scheduled rise to 68 between 2046 and 2048 will actually occur much sooner.

Auto-enrolment In late November, the Department for Work and Pensions announced that the start date for auto-enrolment into pension arrangements for small employers would be put back by 13 months, to May 2015. The full 8% rate of contributions is now likely to apply from October 2018, one year later than previously planned.

For more information and advice on these changes, please contact us.

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

Did you know that from April this year new rules will apply to furnished holiday lets (FHL)? To qualify, the property will need to be available for commercial letting as holiday accommodation for at least 210 days during the tax year and must be commercially let as holiday accommodation for 105 days. Currently the limits are 140 days and 70 days, although even the latter seems long for a UK 'summer'. The property cannot be let for periods of longer-term occupation exceeding 155 days. Since 2009/10, the FHL rules have applied beyond the UK to countries in the EEA.

Investing for growth

The notion that economic growth is good and lack of growth is bad is one of the few things politicians seem to agree on. But as far as investors are concerned, the emphasis on growth can be misleading.

For example, China remains the strongest 'growth story' among major economies, with gross domestic product (GDP) growth in 2011 estimated by the World Bank at 9.1%. Yet over this period the Chinese stock market was down 16%. In contrast, the US, with average GDP growth over the same period of 1.7%, saw its stock market rise by 8%.

So the reality is that national GDP figures tell you very little about the opportunities and prospects for business. Given that economic forecasting is notoriously unreliable, investment managers prefer to focus on business conditions in general and the specific experience of individual companies.

That has led some managers to launch investment funds focusing on what they see as growth areas regardless of the GDP numbers. Examples include:

- **Natural resources** Increasing demand from emerging markets is likely to mean steady growth in revenues and profits for mining and energy companies.
- **Infrastructure** The huge need for new facilities in emerging markets, and renewal of those in the developed world means project managers, planners, builders and engineers can all expect increasing orders.
- **Agriculture and timber** Rising population numbers are driving a need to improve production and productivity.
- **Healthcare** Fast-increasing basic needs in emerging markets plus ageing populations in developed nations mean big growth in demand for medicines and medical services.

There's always value

Meanwhile, another group of investment managers continues to emphasise 'value'. Rather than high growth, what they look for are companies with strong finances, steady businesses and good dividend payments to shareholders. Most such companies are well-established and big; they include oil, pharmaceuticals, supermarkets and utilities.

'Equity income' funds often invest primarily in businesses like these, which may not be entirely recession-proof, but are strong enough to survive and to gain market share from those that don't. So, in investment terms, there are always some good opportunities available regardless of the general economic climate.

The value of your investment can go down as well as up, and you may not get back the original amount you invested. Past performance is not a reliable indicator of future performance.

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Company car tax changes

There is another change to company car taxation due in April.

2012/13 will see the introduction of a new set of company car tax scales originally announced a while ago by the then-Chancellor Alistair Darling. No, that's not an error: the change was revealed as part of the 2009 Pre-Budget Report and legislated for in the following year's Finance Act.

At present, the tax rules are relatively generous for cars with CO_2 emissions of up to 120g/km: the taxable benefit is generally 10% of list price (13% for diesels). Immediately above the 120 g/km level the benefit percentage jumps up to 15% (18% for diesels). From 6 April 2012, this step change will disappear and, at the same time, all thresholds will be moved down by 5g/km. The result will be that if you have a car with emissions of 120g/km or slightly less, your company car tax bill will jump. For example, the taxable value of a BMW 318d ES, which has emissions of 119g/km and a list price of £25,325, will rise from £3,292 to £4,305.

The same proportionate increase will apply to fuel scale charges, making 'free fuel' generally unattractive for low emission cars.

Autumn Statement surprises

The Chancellor's Autumn Statement had a few surprises to set against the gloomy economic forecasts.

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The Autumn Statement, together with a raft of draft legislation issued a week later, has revealed a good slice of what will be in the spring Budget. There is still likely to be the odd rabbit-out-of-the-hat, which all Chancellors find difficult to resist, but the broad outline is clear.

Income tax The main personal allowance will rise by £630 to £8,105 in 2012/13. Other allowances, such as the personal age allowance, will rise by around 5.6%. However, you will not gain the full benefit of the increased personal allowance if you are a higher or additional rate taxpayer, as the basic rate band will shrink by £630 at the same time, leaving the higher rate tax starting point unaltered at £42,475. The £100,000 starting point for phasing out the personal allowance and the £150,000 additional (50%) tax threshold are also unchanged.

National insurance contributions (NICs) After the 1% increase in all rates in 2011/12, NICs rates will generally be unchanged for the coming tax year. The lower thresholds will increase in line with inflation, while the upper thresholds are frozen. However, the changes to contracting out could mean your NICs bill rises in 2012/13 (see 'The pensions revolution continues').

Capital gains tax (CGT) In a surprise move, the Chancellor announced that he would be freezing next tax year's annual CGT exemption at £10,600 rather than increasing it in line with the consumer prices index (CPI), as he had announced he would last March. Mr Osborne justified the freeze as a means of financing a new one year CGT exemption for reinvestment of gains in the new Seed Enterprise Investment Scheme (SEIS – see below).

Tax credits For 2012/13, the child element of the Child Tax Credit (CTC) and disability elements of Working Tax Credit will rise by 5.2%, while all other tax credits will be frozen. However, if you currently receive the family element of CTC, worth a maximum of £545 a year, you may find that it disappears in the new tax year. This stems from a change originally announced in June 2010, bringing down the income threshold at which the credit is phased out from the current £40,000. More recently, there have been reports that the Government is looking at taking CTC away from higher rate taxpayers.

Tax simplification A range of small tax reliefs will be repealed, following the review by the Office of Tax Simplification. These include the 15p a day tax break for luncheon vouchers from April 2013 and, from April 2015, the abolition of life assurance premium relief, currently at a rate of 12.5%.

Seed Enterprise Investment Scheme (SEIS) The Autumn Statement contained a range of business finance initiatives including SEIS, which is an extension of the existing Enterprise Investment Scheme. From 2012/13, the SEIS will offer 50% tax relief on investment of up to £100,000 a year. In addition, for one year only there will be a CGT exemption for any gains reinvested into SEIS companies, potentially adding another 28% tax relief.

The generous tax reliefs reflect the fact that SEIS-eligible companies will be extremely high risk. They must be less than two years old, have no more than 25 full-time employees and possess under £200,000 in gross assets. And the SEIS will not make them that much bigger, as the maximum any company can raise through SEIS is just £150,000.

The value of tax reliefs depends on your individual circumstances. Levels, bases and reliefs from taxation are subject to change. The Financial Services Authority does not regulate tax advice.

Are you making the most of the tax-free personal allowance, which rises by £630 to £8,105 in 2012/13? Many couples waste all or part of the allowance because income is concentrated in one partner's hands. There has been talk that the allowance will be made at least partially transferable, but government finances rule out such an expensive reform any time soon. In the meantime, why not ask us to review whether you can improve the use of your allowances? The value of tax reliefs depends on your individual circumstances. Levels, bases and reliefs from taxation are subject to change. The Financial Services Authority does not regulate tax advice.

Time to revisit commercial property?

Commercial property is an investment sector that has largely avoided the recent market volatility.

While the world's stock markets experienced regular and dizzying bouts of volatility in 2011, UK commercial property returns were very much steadier. At the time of writing, overall returns for 2011 are estimated to be around 8% by the Investment Property Databank (IPD), the property performance measurement company.

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. Past performance is not a reliable guide to future performance.

The secret behind last year's steady performance is that over three quarters of the return is attributable to rental income. Across the commercial property market as a whole, rental levels have held steady, despite the difficult economic conditions. The other component of property returns – capital growth – has almost disappeared. Indeed, commercial property values remain well below their peak levels of June 2007, before the financial crisis hit.

According to the IPD, UK commercial property is attracting interest from a wide range of investors, both based in the UK and from overseas. A recent report suggested that in the City of London over half of all office floor space is now in foreign ownership.

Investment in commercial property is very different from residential buy-to-let. As a general rule, commercial property tenants take long-term leases with regular upward-only rent reviews, and are responsible for the maintenance and insurance of the property. The amount of investment required is markedly different. Whereas the average residential property is worth around £165,000 according to Nationwide, the average value of commercial property in the IPD monthly index is over £9 million.

The high value of investment-grade commercial property means that if you want to invest in this sector, the only practical route is through some form of collective fund. There is now an extensive choice of funds, although some funds with the property label invest in property company shares rather than directly into bricks and mortar. For more details of the underlying strategies of the available funds, please contact us.

Partnership and shareholder protection – shelter in changeable conditions

Smaller businesses are under the cosh, with many battling reduced sales and squeezed funding. Although premiums involve outlay, business protection makes more sense than ever.

For partnerships and shareholders, cover can mean the difference between survival and failure if one of the shareholders or partners dies or becomes critically ill. If no insurance is in place, remaining partners or shareholders will need to raise funds themselves – and that's not easy in the current climate, when banks are barely lending and liquidating a property may be impossible.

There are numerous options in terms of plans, and shareholders or partners should discuss their succession planning aims. We can help to provide cover in the most tax-effective way. It is also crucial that sums insured and the policy's suitability are reviewed regularly.

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There needs to be an accurate valuation of the business and the debt situation needs to be accounted for. Sums insured can change, as can the individuals who need protection – such as when there is a new director or partner – or when one leaves. Indeed, a plan needs to be sufficiently flexible to account for future structure changes.

Keeping a business going can be tough at the best of times, but given the current climate, partnership and shareholder protection may be coming into its own. Please talk to us about the options that are right for your business.

Driving up your savings

In this age of austerity, you may be feeling a bit cash-strapped. If you have a second car, perhaps it's time to think about whether you still need it.

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According to the RAC, the annual cost of running a used car in 2011 was £3,582. The second largest cost of car ownership is depreciation, which the RAC estimates at £1,286 a year.

You'll need to work out your own figures for insurance, car tax, maintenance, fuel and depreciation. It's quite likely that the total will be bigger than you expect. Then the question is: could you use a mixture of public and private transport and spend quite a bit less?

Time to join the club?

If you live in an area where a car club operates, it could be much easier to do without a second car. Many cities now have these clubs, where membership costs £50 a year and small cars can be hired for £5 an hour or £45 a day.

With a bit of planning, many families could probably get by without a second car and save enough to make a real difference to their finances.

Good debt, bad debt

Debt has become almost a dirty word these days, because too many people have too much of it. Paying off 'bad debt' – loans at high interest rates used to buy consumer goods – is definitely the right strategy.

But not all debt is 'bad'. It may not make sense to accelerate repayment of low-interest debts – this is certainly an issue we recommend you discuss with us before taking action.

Daring to say the B word

It's bonus season again, and bonuses are a contentious subject around the turn of the year.

There is a widespread view that in some areas of the financial world – notably investment banks – they are too high. However, in another financial area – with-profits policies – many people believe that bonuses are too small.

The Financial Services Authority (the FSA) has taken an increasing interest in the operation of with-profits funds. Last year the FSA published a consultation paper, 'Protecting with-profits policyholders', after undertaking a 'With-profits regime review'. The paper noted that there had been "deep cuts in annual bonuses, often to zero, and reductions in final pay-outs".

The difficult investment conditions in 2011 mean that this year's bonuses are unlikely to be much different from last year's. However, that does not necessarily mean that any with-profits policies you hold should be abandoned. Any such decision requires a careful individual policy review and an analysis of the alternatives available. This is not an easy task, because public information on with-profits funds can be hard to interpret.

Why not ask us to undertake a review and analysis of your policies for you? You can then decide if you want to wait for next year's bonus.

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