Autumn 2010

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financial focus

Tax planning to the fore

June's Emergency Budget means that tax planning is more important than ever.

In the fortnight before the Emergency Budget, the Government issued many warnings of a period of austerity and the pain that was to come. The Prime Minister said that the budgetary decisions 'will affect every single person in our country. And the effects of those decisions will stay with us for years, perhaps decades, to come'. In the event, the new Chancellor, George Osborne, did not disappoint on 22 June.

The headline Budget increase was to capital gains tax rates and, from 2011, VAT. However, hidden among the Budget announcements, there was a variety of other lower profile measures to help reduce the Government's deficit. For example, the Chancellor followed his predecessor's plan to raise all national insurance contribution rates by 1% from 2011/12.

Next tax year will also see a cut of around £1,650 in the starting point for higher rate tax, compared with Mr Darling's plans, and this threshold will not move in 2012/13. There was also a range of tax credit 'reforms', which could effectively amount to tax increases for many people because they set a lower income ceiling for eligibility. From April 2011, many families (ie those with household incomes in excess of £40,000 a year) will lose their child tax credit payments, worth up to £545 a year.

Realistically, there is virtually no chance of the tax environment improving for the duration of this Parliament. Government borrowing will still be higher in 2015/16 than it was last year, according to the newly created Office for Budget Responsibility. Indeed, there is a risk that taxes could increase further if the spending cuts to be detailed in October do not work as planned.

If you want to minimise the impact of the Emergency Budget changes, your first action should be to review your tax planning. The personal tax regime has been the subject of several major revisions over the past few years, such as the phasing out of personal allowances if your income exceeds £100,000.

As a result, tax plans put in place just two or three years ago may now be out of date. For example, the independent taxation of married couples and civil partners now offers more scope for planning than it did before 6 April 2010. As ever with tax planning, the DIY approach is not the one to choose: in this complex area you need expert advice to avoid the pitfalls.

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

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What did the Chancellor conjure up?

The Emergency Budget

The first Budget after an election is usually the most taxing. George Osborne, the new Chancellor, did not stray from the tradition.

The Budget on 22 June was variously billed as 'the Emergency Budget' and 'the Austerity Budget'. In the event, it was the now familiar Budget mix of immediate tax increases and deferred tax increases with the odd (low cost) sweetener:

VAT

The standard rate of VAT will rise to 20% from 4 January 2011, the first working day of the new year. The result will be a 1.5% increase in annual consumer price index inflation.

Capital gains tax (CGT)

This was the hot topic in the run up to the Budget, but the announced revisions, which took effect from 23 June 2010, were less draconian than feared. The annual exemption remains at a generous £10,100 and will continue to be index-linked.

Capital gains (after the annual exemption) are now taxed as income, but at special rates. The main rate of tax is 18%, but for gains which fall into the higher and additional rate bands, a 28% rate applies. Gains made before 23 June 2010 will be taxed on the old 18% flat rate basis.

The lifetime limit for entrepreneurs' relief was raised to £5 million: Mr Darling had raised it to £2 million in his March Budget.

Business tax

The main corporation tax rate will fall by 1% a year for four years from April 2011, leaving a 24% rate from 1 April 2014. The small profits rate (formerly small companies' rate) will be cut by 1% to 20% from April 2011.

However, the annual investment allowance will fall from £100,000 to £25,000 in April 2012 and the plant and machinery capital allowances will be cut at the same time.

Personal allowance and tax bands

The personal allowance will rise by £1,000 in 2011/12 to £7,475, but if you are a higher rate taxpayer you will not benefit because the starting point for 40% tax will be reduced to claw back the potential tax saving. The higher rate tax starting point will then remain frozen for 2012/13, again potentially creating more 40% taxpayers.

National insurance contributions (NICs)

The previous Government's planned 1% rise to all the main NIC rates will go ahead for 2011/12. However, adjustments to the NIC bands will temper the impact of the higher rates for both employers and employees.

Pension contribution tax relief

The Chancellor has abandoned the much-criticised 'high income excess relief charge', which had been due to replace the 'special annual allowance charge' from 2011/12. However, he plans to impose new restrictions on pension contribution tax relief, probably by reducing the annual allowance from £255,000 to between £30,000 and £45,000.

As a result of this proposal, 2010/11 may be the last tax year in which you could benefit from full tax relief on a substantial pension contribution, whether made by you or your employer. There were also moves to end the effective requirement to buy an annuity by age 75 (see 'No more annuities!' on page 7).

Tax credits

The fact that it has been possible to have a family income of over £50,000 and still receive child tax credit (CTC) always looked like low-hanging fruit for a revenue-hungry Chancellor. So it proved to be. A range of money-saving 'reforms' to the tax credit system were announced.

For example, the starting income level for clawing back the family element of CTC will drop to £40,000 in 2011/12, and the claw back rate will jump from 6.67% to 41%.

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

Did you know that the biggest single piece of good news in the Budget for investors was that individual savings account (ISA) ceilings have not only been maintained at the increased rate set by the outgoing Government, but have finally been index linked? This frees the savings industry from the yearly round of lobbying the government to raise limits just to avoid inflation erosion. If inflation holds close to target, the current individual £10,200 allowance, £5,100 of which can be saved in cash, should rise by about 2% each year. For the 20 million people who already hold an ISA, higher capital gains tax makes them all the more valuable.

Anyone for some income?

The base rate has remained at 0.5% for well over a year now. There are few signs that it will rise much in the near term.

When the Bank of England cut the base rate to 0.5% in March 2009, there were not many who predicted that it would be the last change until at least the second half of 2010. The Bank's own calculations, in its May 2010 Inflation Report, show that the base rate is now not expected to reach 3% until the beginning of 2013.

If you rely on bank or building society deposits for income, the expected slow progress of interest rates back towards normality is unwelcome news. It means that even fixed term rates are relatively low, with a 4% gross rate unavailable for terms below three years.

One way to increase your income is to move away from deposit-based investments. You will lose the security of capital which deposits provide, but if your ultimate goal is income, you may consider that to be a price worth paying. With the right type of investments, your future income would be free from the ups and downs of short-term interest rates. Your choice should be based on your individual circumstances and attitude to risk, and you should seek professional advice before investing.

The potential list of investments includes:

- **Fixed interest funds** which invest in interest-paying securities issued by companies, governments and a variety of other bodies. At present, yields on UK government securities (gilts) are low, with ten-year gilts yielding below 3.5%. Away from the gilts market, income yields on other fixed interest securities, notably corporate bonds, are more attractive.
- **UK equity income funds** which generally invest in higher yielding UK company shares. These types of funds have long been popular because of their potential to provide rising income in the long term. The choice of funds needs care, as some – including at least one major name – have not performed to expectations.
- **Overseas equity income funds** which are the global equivalent of UK equity income funds. The UK has traditionally been one of the higher yield global equity markets and investing overseas used to mean investing primarily for growth. However, yields have increased globally and a growing number of investment managers are now offering income funds based on markets outside the UK.

All of these funds can be held within individual savings accounts (ISAs). The fixed interest funds make especially attractive ISA income investments because there is no tax on the interest. For equity funds, ISAs only give you shelter from higher or additional rate tax – there is usually no income tax benefit if you are a basic rate taxpayer.

If you have an existing cash ISA – perhaps one that started life as a TESSA – you can transfer it to a stocks and shares ISA and invest in income funds. This is a one-way transfer – there is no going back to the security of cash – and your ISA provider may levy transfer charges. However, you could see a big jump in income: the average cash ISA is paying under 0.5% interest according to the Consumer Focus super-complaint on cash ISAs issued earlier this year.

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.

Footnote If you invested in the briefly available one-year issue of National Savings & Investments Income/Growth Bonds last autumn, they will mature soon. It is unlikely you will be offered 3.95% again.

Socially responsible investment

Sustainable and ethical investment is growing in popularity, from investing in clean power to shunning child labour. It is meant to be good for everyone – but is it bad for your rate of return?

Socially responsible investment (SRI) has been active in the UK since 1984. British savers had put more than £9.5 billion into green and ethical retail funds by the end of Q2 2010. Some are attracted by the idea of 'doing good' with their money, while others see sustainability as offering long-term performance potential that less long-sighted businesses might miss out on.

There is no one definition of ethical investing. Early funds selected stocks to buy using 'negative filters' to exclude unethical operators or producers of morally controversial products and services. This filter catches companies that may, for example, pollute or destroy the environment, exploit workers, abuse human rights, be involved in the weapons trade or produce tobacco products.

However, more popular today are 'positive filters'. These favour companies that are, for example, active in environmental technology, clean energy, healthcare, or have been successful in promoting human rights, equal opportunities or welfare standards throughout the supply chain.

The huge variety of decision-making approaches demonstrates one thing very clearly – there is no universal definition of what is ethical. For example, smokers are not likely to want to boycott tobacco companies, while the commercial chicken farmer may not mind investment in pesticide manufacturers or vendors of battery-farmed eggs.

Fortunately, the growth of the market means there is now plenty of choice. Those seeking green and ethical funds for their portfolio can choose from around 100 different funds, compared with just a handful a decade ago. A recent Ipsos/MORI poll showed that for 44% of the British public, the ethical credentials of financial products and services are important.

The key reservation for potential investors is performance: do such 'virtuous' funds generate inferior returns? When it comes to performance, the answer is, as always, it depends. If sectors that these funds cannot invest in are doing well, they are likely to underperform, and vice versa. Moreover, ethical screening reduces the investments available, and has a tendency to exclude companies with very large market capitalisations, both of which increase volatility. The funds with the strictest selection criteria, sometimes termed 'dark green', are most vulnerable: very strict screening can bar entire industry sectors from inclusion.

But this may change as more mainstream companies embrace green and ethical ideals and the investment universe for these funds grows, removing obstacles to performance. Fund managers can make decisions about which ethical companies they predict will perform well, focusing on picking winners rather than just avoiding sinners.

There is also great potential for green companies to benefit from government and legislative support, while surging commodity prices mean that sustainable energy generation and recycling make sound economic sense for a business. Those who get in early are likely to benefit most.

There is a multiplying range of ethical funds out there, but there is some evidence that their performance lags behind that of their unfiltered peers. While this discrepancy may decrease in the future, it is something savers need to consider when making investment decisions.

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.

Are you ready for 31 October? If you prefer to complete your 2010 tax return on paper rather than online, then HMRC must receive the return by Sunday, 31 October 2010. Miss that date and you face an automatic penalty of £100 unless you subsequently file online, which gives you another three months' leeway. Whether you choose paper or online, any tax balance due for the 2009/10 year and your first payment on account for 2010/11 will be due on 31 January 2011. If your income has fallen, you can ask for your payment on account to be reduced using form SA303.

Good things in small packages?

Is smaller better? In the wake of the BP disaster, small and medium enterprise (SME) funds can look alluring.

The ongoing worries about BP and its tattered share price show how vulnerable a big firm can be when public opinion swings against it. It's worth taking a look at funds that invest in small and mid-sized companies.

Companies with the largest market capitalisation have a lot to offer. They are frequently well diversified internationally, by business type and/or by customer base – GlaxoSmithKline sells pharmaceuticals, energy drinks and diet supplements in over 100 countries. They also typically have a reputation for paying regular and reliable dividends, which allows fund managers a degree of confidence in performance.

So it came as a particular shock when BP announced in June that it was suspending dividend payments to shareholders, to ensure its Gulf of Mexico compensation fund was sufficient. The company's share price has been equally shocking – from a peak of £6.58 in April, it has dropped as low as £2.96 in June. Due to its high profile, an avalanche effect took place, exacerbated as a number of ethical funds decided to drop the company entirely.

However, savers in the UK can choose from a wide variety of stock funds, including those that focus solely on small and mid-sized companies. They, too, have much to offer savers. While these companies do not have the advantage of enormous size, a lower profile makes them less vulnerable to swings in public sentiment and they can be more adaptable to changes in technology or the business cycle, such as a pickup in consumer spending. They are also often keen to please shareholders, using dividends or returning shares.

With some big-capital companies disappointing, savvy fund managers can pick up stocks with good potential at very low prices – the UK FTSE 100 has never recovered to the heights of 2007, when it was heading towards 7000 points. It is still languishing closer to 5000. That means that in the world of stocks, there are plenty of bargains to be had for those prepared to search.

The Budget was also kind to small capital companies – hardly surprising when you consider SMEs are the backbone of the entire continent's economies, accounting for 99% of all European enterprises and providing two-thirds of all private sector jobs. The Government has cut corporation tax from 21% to 20% from 2011/12 for smaller firms (companies with less than £300,000 of profits), and for larger firms from 28% to 24% by 2014/15. The threshold on employer national insurance has also been raised.

But a good fund manager is essential. With a much wider range to choose from, selection becomes more important than ever – there are not just 100 or even 250 firms to choose from, but thousands. While past performance is no guarantee of future earnings, it can help you to weed out those whose selection process has not delivered value to investors in the past.

Smaller capital funds bring a host of advantages to savers, and diversifying your investments is always important. But smaller firms, though well-placed to benefit once economic recovery takes root, may struggle as long as the economy remains subdued, leaving these firms highly vulnerable to a double-dip recession.

The value of shares in smaller companies are often more volatile than those of larger corporates. 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.

The last years of the 'cheap' degree?

The 2010/11 academic year could be one of the last before a major overhaul in university funding.

How should higher education in England be funded? Last November the previous Government asked Lord Browne to investigate and make proposals: his report is due soon. The post-election timing of the findings was important because the early signs are that there will be a recommendation to raise the cap on annual tuition fees from £3,290 for the coming year to £7,000 by 2013. It may possibly be removed completely in the longer term.

The new Government is similarly concerned about university costs, but faces its own political difficulties with raising tuition fees. The Liberal Democrat's manifesto proposed that fees should be scrapped, but the coalition agreement did not, preferring to await Lord Browne's findings. Vince Cable, the Business Secretary, has already started to talk about a 'graduate tax', although this raises serious practical questions, such as what happens to graduates who work overseas. The graduate tax would probably look similar to the current loan scheme. At present, a graduate with income over £15,000 and an outstanding student loan has to make loan repayments equal to 9% of their earnings over £15,000 – effectively an extra 9% on their tax rate over £15,000. The student loan does not carry interest, but is revalued each year in line with RPI inflation in March – 4.4% for 2010.

Whatever the Government decides to do, the cost of university education looks set to rise sharply. Even if the graduate tax arrives, the issue of graduate debt will not disappear. There are no plans to replace maintenance loans, which can be up to almost £7,000 a year. In fact, there is a possibility that all loans will start to carry a commercial rate of interest rather than continue with the effective subsidy of simple inflation-linking.

If you have children – or grandchildren – and do not want them to start their careers with a large debt, then the sooner you start planning for their university costs, the better. Just imagine if your working life had started with a debt equal to your annual salary...

No more annuities!

The Emergency Budget signalled an end to the effective requirement to buy an annuity income with your pension fund.

If you have not yet reached the age of 75, then you may never have to buy an annuity or otherwise take an income from your pension fund. The Chancellor announced as an interim measure that the requirement to take an income could be put off until age 77, while new rules are finalised. In a subsequent consultation on these, the Treasury has proposed, among other things:

- Capped and flexible income withdrawal options, for those not wishing to purchase an annuity. Anyone using the flexible option will have to satisfy a secured minimum income requirement.
- Payment of benefits, including tax-free lump sums, may be postponed beyond age 75, although they'll still be tested against the lifetime allowance by 75.
- An end to alternatively secured pension (ASP) rules including removing explicit inheritance tax charges on pension funds post 75. Existing ASPs would become subject to the revised income withdrawal rules.

If you are close to drawing benefits from your pension fund or nearing age 75, the proposals may complicate your decision, not least because many providers are not yet able to cope with the interim changes. Before taking any action, make sure you seek our advice.

Did you know that Government contributions to the child trust fund (CTF) scheme will end in December? From 1 August 2010, the Government cut initial payments to a CTF from £250 to £50 and reduced the additional payment by the same amount. Payments at the age of seven, which had been £250, stopped. From the start of 2011, no new CTFs will be created, but existing ones will remain in being, with their tax treatment unchanged and personal top ups of up to £1,200 a year still possible. Other ways of saving for children – of which there are many – are unaffected.

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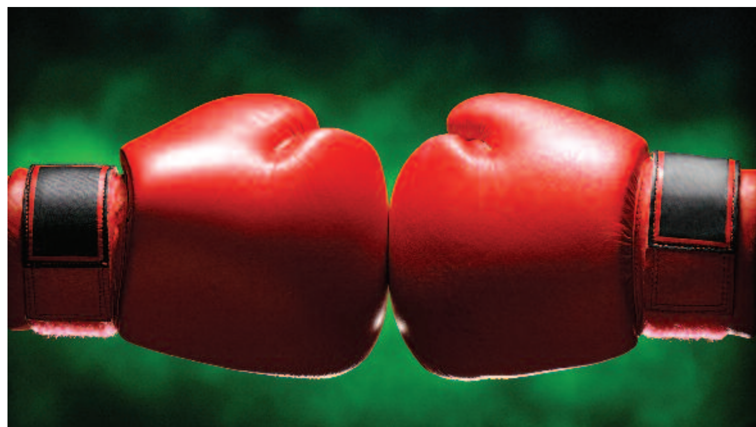
Battle of the indices: CPI vs RPI

One surprise in the Emergency Budget on 22 June was the Government announcement that it would use the consumer prices index (CPI) rather than the retail prices index (RPI) for benefit, tax credit and public sector pension increases from 2011.

A few weeks later the Pensions Minister, Steve Webb, sprang another surprise by stating that CPI rather than RPI would also form the basis for statutory increases to private sector defined benefit pensions from 2011. The move from RPI to CPI may not sound significant, but it could make a big difference to your retirement income.

The CPI measure of inflation is generally lower than the more familiar RPI. For example, between January 1990 and January 2010, the RPI rose on average by 3% a year against 2.5% for the CPI. Over 20 years that 0.5% difference translates into a total inflation of 82.3% on an RPI basis and 63.8% for the CPI – over 22% less.

If you are a member of a defined benefit pension scheme, you may



not automatically be worse off; for example your scheme may offer more generous pension increases than the statutory minimum. As is often the case in pensions, the devil is in the detail and, crucially, this is distinctly lacking from all sides at present.

Budgeting for Britain's future – and yours

The UK's Emergency Budget aims to raise £40 billion, and forms part of a plan to reduce significantly the nation's record £155 billion deficit within five years. But what does it mean for savers?

An end to compulsory annuity purchase

A welcome change is ending the requirement to use a pension fund to buy an annuity. Previously, anyone who had reached the 'pivotal' age of 75 and hadn't made a decision about taking an income from their pension had to cash their pension into an annuity or switch to other little known and inflexible options. This constraint has gone, initially to be replaced by a temporary extension of the 'pivotal' age to 77. In the meantime, a consultation period is being used to debate the detailed, final rules that we expect to apply from April 2011.

But we will work for longer

Those with a state pension scheme will find their accruals linked to wage inflation – they will receive the higher of average earnings inflation or price inflation, whichever is greater, with a minimum of 2.5%. That is reassuring, given that the Budget also included an inflation-dampening two-year freeze on public sector pay. The Chancellor also confirmed plans to bring forward the raising of the state pension age to 66, which is currently due to start taking effect in 2024.

Capital gains rise – but so will ISA limits

A painful announcement was the increase in capital gains tax (CGT) for high earners to 28% from 18%. This will be particularly harsh on those who have been investing in property. The yearly tax-free amount remains at £10,100 but will rise with inflation. This makes ISAs even more attractive, as their investments are not subject to CGT.

No change to nil rate on inheritance tax (IHT)

There was some expectation that the Chancellor would introduce a new nil rate on inheritance up to £1 million, but disappointingly this did not happen. So couples whose assets top £650,000 still face IHT when they die.

Savers get off lightly

All in all, savers have not fared badly in the Budget. ISAs look more valuable than ever, though, so those who might not be using their full ISA allowance may wish to remedy that shortfall.

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