financial focus

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Can't see the wood for the trees?

When you feel daunted by the idea of financial planning, it often pays to step back, ignore all today's news and take a long-term view.


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And taking a long view is exactly what the Office for Budget Responsibility (OBR) has done in its first 'Fiscal Sustainability Report', published in July. The OBR, which was set up by the current Chancellor, will normally produce independent five-year Budget forecasts for the government. Its new report, however, adopts a much longer timescale – 50 years – and starts where the Budget projections end, which is in 2015/16.

The report does not make comfortable reading. Even if the current austerity programme works as planned – and that is a big 'if', given the recent poor economic growth figures – there will be no scope to cut taxes after 2015/16. The main reason is the ageing of the UK population. About 26% of us are projected to be aged 65 or older by 2061, compared with 17% today. This increase will add a huge amount to government spending (£80 billion in today's terms) spread across three main areas:

- **Health expenditure** will rise by about a third, so that in 2060/61 it will account for almost 10% of the UK economy.
- **State pension costs** will jump by over 40%. This is not just a reflection of more pensioners (even with later state pension ages), but also the maturing of state second pension (S2P) entitlements and the higher increases now being given to the basic state pension.
- **Social care costs**, largely consisting of long-term care funding, will increase by two thirds, even before any extra outlay resulting from the Dilnot review (see 'Meeting the cost of care' on page 4).

There are some offsetting increases in Government revenue, notably from a sharp jump in inheritance tax payments, but these are nowhere near enough to match the additional expenditure. In the OBR's view, taxes will need to increase by £22 billion in today's terms in 2016/17 to bring government borrowing down to a sustainable level. So in theory, any hopes the current Government had for tax cuts before the next general election (scheduled for 2015) should be abandoned.

The OBR has reminded us that we are probably nearing the limits of state assistance in retirement and old age – the OBR does not assume any changes to the current system, beyond those already announced. The implication is that in the long term, how comfortable your retirement will be will depend upon the savings that you make while still part of the working sector of the population.

Pension planning

'...the clock is already ticking...'

for 2012/13

It may seem some months away, but it is already time to start thinking about pension planning for the next tax year.

The changes to pension rules made by the Coalition Government have been many and various. At times the process has seemed to be too fast, while on other occasions implementation has been painfully slow. The end result has been that pension reforms have not happened in one big bang, but take effect from several different dates.

Annual allowance

On 6 April 2011, the annual allowance, which effectively sets your maximum tax-efficient pension contributions during a tax year, was cut from £255,000 to £50,000. At the same time a new 'carry forward' facility was introduced, which allows you to take advantage of any unused annual allowance from the immediately preceding three tax years. The rules for carry forward are complex.

One key point is that carry forward is a use-it-or-lose-it facility. So if you do not mop up any unused annual allowance for 2008/09 before 6 April 2012, it will be lost forever. The data needed to calculate carry forward can be difficult to obtain, so the sooner you start planning, the better.

Lifetime allowance

From 6 April 2012, the standard lifetime allowance, which effectively sets your maximum tax-efficient total pension benefit value, will be cut from £1.8 million to £1.5 million.

The Government has also introduced some relaxation here in the form of 'fixed protection'. You can continue to benefit from a minimum lifetime allowance of £1.8 million if you elect for fixed protection. However, there are several hurdles:

- If you already have so-called 'enhanced protection' and/or 'primary protection', you cannot also opt for fixed protection.
- An election must be made to HM Revenue & Customs by 5 April 2012, which means that the clock is already ticking.
- Broadly speaking, fixed protection will only remain in force provided that after 5 April 2012 no contributions are made to your pension arrangements and you accrue no new benefits.

If you opt for fixed protection, it may make sense to maximise your contributions and/or pension accrual before the end of this tax year – subject to the constraints imposed by the lowered annual allowance.

Flexible drawdown

Flexible drawdown is a new form of income drawdown, under which there are no limits on the level of withdrawals you can take. In theory it became available from 6 April 2011, although as the finalised legislation arrived in mid-July, many providers are only now starting to offer the facility.

To be eligible for flexible drawdown you must have pension income in payment (from the state, pension annuities and/or scheme pensions) of at least £20,000 a year for the rest of your life. In addition, in the tax year in which you opt for flexible drawdown you must not have made or benefitted from any contributions to a money purchase pension scheme, such as a personal pension. You can be a member of a defined benefit (e.g. final salary) scheme during the tax year, but you must stop accruing fresh benefits before opting for flexible drawdown.

If you are thinking of using flexible drawdown in 2012/13, once again you should consider maximising pension contributions in the current tax year.

Flexible income drawdown carries investment risk. If you are concerned by the possible effects the ups and downs in the stock market could have on the level of your withdrawals, an annuity could turn out to be a better option. Flexible drawdown is a complex area of pensions and it is not suitable for everyone. If you are considering this option, you must seek independent advice.

Did you know that, in June, a small bank called Southsea Mortgage and Investment Company was placed in administration by the Financial Services Authority (FSA)? It was the first such failure of a deposit-taking institution since the problems encountered by Dunfermline Building Society in 2009. The Financial Services Compensation Scheme's new faster compensation payments system kicked in and the 'vast majority' of Southsea's depositors received compensation the day after the FSA acted. On this occasion compensation was not unlimited – the new £85,000 ceiling introduced in December 2010 was applied. That change of approach is worth noting if you have large deposits with any one bank or building society.

Meeting the cost of care

The latest in a long line of Government-sponsored reports into long-term care funding has been published. This one might not end up being left on the shelf.

Who pays for any care that you may need in old age? At present, the answer is far from simple. The four parts of the UK each have their own system, with Scotland the only country providing a payment for personal care costs that is not means-tested. In England, the level of support can depend on where you live, because each of the 152 local authorities sets its own charging policies for domiciliary care, even though a national system applies to residential care charges.

The previous Government published a Green Paper on long-term care in England in July 2009, but it was widely seen as a move to sideline a difficult issue until after the election. The Coalition Government's response was to set up a commission to review care shortly after coming to power. That commission, chaired by the economist Andrew Dilnot, issued its report ('Fairer Care Funding') in July and made the following proposals (which only affect England):

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- Your lifetime contribution to your care costs should be capped at 'between £25,000 and £50,000'. The commission thought £35,000 was 'an appropriate and fair figure' for those aged 65 and over. At present, if the state does not support you, there is no cap on what you might have to pay.
- If you have capital of more than £23,250 there is no state support at present, other than £108.70 a week if you require nursing care. The commission proposed that this capital means test upper limit should be increased to £100,000. The lower means test limit of £14,250, below which all your costs are met, should remain unchanged in the commission's view. The upper limit change is not as generous as it seems because, between these two limits, you would (as now) have to make a contribution of £1 a week per £250 of capital. So, if you had £89,250 of capital, you would be expected initially to contribute £300 a week.
- Regardless of what state support you receive, you would be required to make a payment to cover your general living costs if you are in residential care. The commission suggested that 'a figure in the range of £7,000 to £10,000 a year is appropriate', although its calculations were based on the higher number.

If implemented, these proposals would put an end to the current situation in which you could lose up to 90% of your accumulated wealth if you go into care. However, the commission's plans could still leave you with a capital cost of up to £35,000 plus having to find £10,000 a year. Even this is not quite the full story, because the £35,000 cap is based on your local authority's 'typical' cost for care, not your actual expenditure, which could be much higher.

The Government's response to the commission's report has been to set in train more consultation and the promise of a White Paper next spring. This procrastination may be because to implement the proposals would cost a net £2.2 billion a year in 2015/16 (assuming a cap of £35,000), money the Government does not have.

Unfortunately for now – and probably for the longer term – care costs will remain another element to factor into your retirement planning. This might explain why the Government has made changes to allow you to delay drawing some or all of your pension benefits until after age 75.

If you prefer to complete your tax return on paper rather than file via the internet, have you remembered that the deadline of 31 October is approaching? This year HM Revenue & Customs has a new set of penalties for late filing which is much harsher than previously. For example, if you are one day late with your return, the fine is £100, even if you have no tax to pay, whereas before no tax due meant no fine. After three months there is now an additional penalty of £10 a day. The Financial Services Authority does not regulate tax advice.

Is higher rate tax relief to go? In the summer, the *Sunday Telegraph* ran a story suggesting that the Chancellor was considering the abolition of higher (and additional) rate tax relief for pension contributions, a move which would save £7 billion a year. The article was given added weight by the fact that its author, Michael Johnson, served as Secretary to the Conservative Party's Economic Competitiveness Policy Group before the election. Complete abolition seems unlikely, at least in the short term, given the changes that have already been made by Mr Osborne to limit pension tax relief. The value of tax reliefs depends on your individual circumstances. The Financial Services Authority does not regulate tax advice.

Securing your income

What would happen if illness forced you to stop working? Recently published statistics from the Department for Work and Pensions (DWP) suggest that help from the state may be hard to come by.

Taking incapacity benefit was once seen as a better option than claiming unemployment benefit. It was suggested in some quarters that governments indirectly encouraged claimants to draw invalidity benefit (as it was then) rather than add to the unemployment numbers. However, the law of unintended consequences soon took over and the number of claimants rose from around a million in the mid-1980s to more than 2.5 million by the turn of the century.

The huge outlay involved prompted governments of all hues to introduce reforms to reduce the cost to the Exchequer. The latest of these initiatives was the introduction of Employment Support Allowance (ESA) in October 2008 as a replacement of Incapacity Benefit (IB). Initially IB remained for existing claimants, but by 2014 they should have all been moved over to the ESA regime.

ESA has a distinctly different focus from IB. A key feature of ESA is the Work Capability Assessment (WCA), which is carried out during the first 13 weeks of the claim. During that period your basic benefit payment is £67.50 a week (for a single person aged 25 or over), the same rate as Jobseeker's Allowance. As the name suggests, the WCA is a measure of what work you can do. Under IB, the assessment was more a gauge of your disability than your ability. Once the WCA is over, you are allocated to one of three groups:

1. **'Fit for work'**, with no further ESA entitlement.
2. **'Work Related Activity Group'**, with a basic benefit of £94.25 a week. To maintain your entitlement to the full level of benefit you must comply with ESA work-related conditions. For example, you could be required to attend regular work-focused interviews with a personal adviser. From April 2012 this benefit is likely to be paid for a maximum of 12 months in many instances.
3. **'Support Group'**, with a basic benefit of £99.85 a week. This category only applies if you are considered to have 'a limited capability for work-related activity'. Claimants qualifying for this higher level of benefit do not have to undertake any work-related activities.

Statistics recently released by the DWP show that the assessment process has markedly limited the chance of a successful benefit claim. For the period covering claims since the start of ESA to the end of November 2010, initial assessments produced the following results:

- 39% of claimants were deemed to be 'fit for work'.
- 17% of claimants were placed in the 'Work Related Activity Group'.
- 7% of claimants were placed in the 'Support Group'.
- 36% of claims were closed before the assessment was completed.
- 1% of claims are still in assessment.

These statistics – and the lowly benefit levels of successful claims – are a stark reminder of the importance of having adequate income protection. The best income protection plans pay out if you are unable to follow your 'own occupation'. This is a much lower threshold than applies for the WCA, which basically only allows the highest 'Support Group' payment if you are unable to follow any occupation.

If you do not have income protection, or your current cover needs review, you owe it to yourself and your family to take action now.

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A Saturday year-end?

If your company's financial year end is Saturday, 31 December, it will soon be time to start planning.

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No two years are the same in business and that is just as true for planning what to do with your company's profits at the year end. Successive Chancellors have tweaked the tax rules in many areas, so that every time 31 December rolls round the picture is slightly different. 2011 is complicated by a variety of measures:

- **Income tax** In 2011/12 the starting point of higher rate tax (40% on earnings, 32.5% on dividends) is £1,400 lower than it was in 2010/11 because of changes to the basic rate band (down £2,400) and the personal allowance (up £1,000). We already know that there will be no change in the starting point for higher rate tax in 2012/13.
- **National insurance contributions (NICs)** The main rates for employers and employees all rose by 1% for 2011/12, but the size of the band subject to the full employee rate (normally 12%) shrank.
- **Capital gains tax (CGT)** The lifetime limit for entrepreneurs' relief, which reduces the rate of tax on gains on business assets to 10%, was doubled to £10 million for 2011/12.
- **Corporation tax** The small profits (formerly smaller companies') corporation tax rate fell by 1% to 20% from April 2011. The mainstream rate dropped by 2%, to 26%.
- **Capital allowances** The annual investment allowance (a 100% allowance for plant and machinery expenditure) remains at £100,000, but will fall to £25,000 from April 2012. From the same date the main writing down allowance for plant and machinery will be cut from 20% to 18%.
- **Pension contributions** New rules for pension contributions and benefits mean several changes to your pension options, as we explain in 'Pension planning for 2012/13' on pages 2–3.

There is no simple rule of thumb for the impact of this amalgam of past and future changes. In the final analysis, your 2011 year-end planning will be driven by your, and your company's, circumstances. However, there are several areas worth reviewing:

- You may want to maximise your pension contributions this year, because:
  - You want to exploit carry forward from 2008/09; or
  - You will be claiming fixed protection and ceasing company contributions from 2012/13.
- Bringing forward investments in plant and machinery could make sense because the reductions in the annual investment allowance and capital allowance rates will start to take effect in your company's next financial year.
- If you want to extract income from your company, you should consider drawing dividends rather than salary to save NICs. This year the numbers are even more convincing, as the table shows.

Bonus v Dividend in 2011

	Bonus £	Dividend £
Marginal gross profit	50,000	50,000
Corporation tax	N/A	(10,125)
Dividend	N/A	39,875
Employer's (NICs) £43,937 @ 13.8%	(6,063)	N/A
Gross bonus	43,937	N/A
Director's NICs £43,937 @ 2%	(879)	N/A
Income tax	(17,575)	(9,969)
Benefit to director	25,483	29,906

Assumptions:

1. Company's marginal corporation tax rate is 20.25% for calendar year 2011.

2. Director's marginal income tax rate for 2011/12 is 40% (32.5% for dividends less 10% tax credit).

3. The personal service company rules (IR35) do not apply.

If you wish to explore these options further, why not call us to arrange a meeting?

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

Foreign FTSE 100

Allocating to the good old FTSE 100 may no longer give your portfolio a slice of British business, as international exposure and a heavy bias to commodities have skewed this former lodestone of UK plc.

With commodities giant Glencore barging into the index this summer, exposure to resource stocks, such as mining and oil and gas firms, has risen to more than a third of the entire index, with names like Anglo American, BG Group, BHP Billiton, BP, Rio Tinto and Royal Dutch Shell figuring prominently.

A British name doesn't mean a British business…

And don't let the English overtones of the names cloud your vision – with the exception of North Sea oil, few resources are carved out of British geography. Investing in energy stocks means exposure to the Gulf region, Latin America and Siberia, with major growth areas in Venezuela and Kazakhstan.

Metals extraction, too, necessitates exposure mostly to emerging markets – for example, the biggest copper producer is Chile, for iron, it is China and, when it comes to gold, China is also number one, having overtaken gold-producing stalwarts like Australia and South Africa.

…and neither does a UK listing

The confusion stems from the criteria needed to become an index member – firms don't have to be based in the UK, they just have to have their shares traded here. And the gravitas of a UK listing isn't the only benefit enticing them to do just that. Index-matching funds will be mandated to allocate money to these stocks once they are FTSE entrenched, guaranteeing a base level of demand for the shares unless their price drops sharply.

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The result is that those keen to avoid emerging markets exposure can't look to the FTSE to provide this, and those gauging their exposure could be very surprised if they drill below geographic listing to actual operations.

Investing = international

While the FTSE 100 may be an extreme example, the global nature of modern business means no company can be immune from international business developments. FTSE 100 powerhouses Marks & Spencer and Sainsbury's may sell mostly to British buyers, but much of their stock comes from overseas.

Unless you are prepared to hide your money away in government bonds and pounds, and accept the pitiful returns on offer, today's savvy savers know that investing means international exposure.

Past performance is not an indicator of future performance. The value of your investments can go up or down, and you may not get back the original amount invested.

Investing in Europe – still worth it?

Europe isn't all bad – some sectors have never had it so good.

"Debt crisis!" "Default!" "Euro faces meltdown!" Anyone who has picked up a newspaper recently could be forgiven for believing that once you have crossed the Channel, the population of an entire continent is either unemployed or on strike, and spends its free time rioting in protest against Government cuts and working out how to avoid paying taxes.

Far from it…

Outside of the three most embattled peripheral nations, which make up just 6% of the euro zone's GDP, much of euroland is doing well. Despite more modest than expected results, Germany's GDP growth of 1.5% in the first quarter of 2011 was still its fastest year-on-year growth since reunification in 1990. Setting aside the little "P.I.I.G.S", namely Portugal, Ireland, Italy, Greece and Spain, every country in the euro block is posting positive growth.

If you want to pick sectors, German car-makers are clocking up record profits as they thrive on exports to China. But car makers are not the only winners: in 2010, German exports expanded 18%, fuelled by demand from expanding emerging market nations, whose economies are growing even more rapidly, for goods like telecoms and pharmaceuticals.

So don't write off Europe just yet – the fog of bad headlines is obscuring core strength and a wealth of investment opportunities.

Past performance is not an indicator of future performance. The value of your investments can go up or down, and you may not get back the original amount invested.

Paying to learn

Decades of subsidised degrees grind to a halt next year, when many universities will be charging students the maximum possible fees for their courses. It may be a lot more than you bargained for.

Learning to pay

2011 marks the last year of low-cost academic fees. From 2012, most of Britain's universities have been given the green light to charge a whopping £9,000 for each year of study. That means that for a full-time student, just the cost of education, before you start to incorporate living costs, travel or even text books, will nearly triple to £27,000 for a three-year course. For longer courses – such as medicine, which can take six years – you are looking at £54,000.

There are also loans for living costs, which (from September 2012) amount to £5,500 for students studying away from home but rise to £7,675 for those studying in London. Assuming that students can make that stretch to actually cover their costs – a big assumption, especially for those whose terms are longer such as veterinary, dental or medical students – that points to a basic graduate debt of £50,000 on a three-year course based in London, or a shocking £100,000 for a six-year degree. By comparison, sending a child to senior boarding school in the UK costs an average of almost £24,000 a year.

Payback time?

The terms of the loans appear quite generous at first glance. No payments are demanded until borrowers are earning more than £21,000, and then you are charged a maximum of 9% of your earnings over that threshold. On a salary of £25,000, that amounts to around £30 a month, or closer to £600 a month on a £100,000 salary. There is no potential for deferring – repayments will normally be taken automatically from a graduate's salary.


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Bear in mind, though, that interest is also charged. Student debt goes up at the rate of inflation plus 3% while you study, and at inflation thereafter. With the retail prices index currently at 5%, that's not a trivial rate. The good news? Anything that hasn't been paid off after 30 years is written off.

The cost of higher education has never been higher, and student loans may not cover the full cost. Please contact us so we can make sure you are prepared.

Nearing NEST

The deadline is getting closer…

The National Employment Savings Trust (NEST) is due to launch in October 2012, little more than a year away. NEST is a Government-initiated default pension scheme, primarily aimed at low to medium earning employees who have no, or very limited, employer pension provision.

NEST will be supported by auto-enrolment rules which, over the following three years, will place most tax-paying employees in the scheme if they are not enrolled in a suitable alternative pension arrangement offered by their employer.

In one form or another – the concept was originally called Personal Accounts – NEST has been in development for over five years. The first NEST framework legislation dates back to 2007. The auto-enrolment legislation followed in 2008, but the ACA's 'Smaller Firms' Pensions Survey', published in January 2011, revealed that only one in five businesses employing 250 or fewer employees had budgeted for the associated contribution costs.

If your business has not yet fully considered the impact of NEST and auto-enrolment, now is the time to start. While the long phasing in schedule means it could be the second half of 2015 before some small employers come within the ambit of NEST and auto-enrolment, your employees could well be asking questions much sooner.

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