financial focus

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A new pensions world

6 April is often an important date in the pensions world.

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In 2006, 6 April marked the start of a new pension tax regime, and last year it heralded the beginning of new basic state pension rules. 6 April 2011 saw the start of another round of major pension tax changes, adding a further layer of complexity to 2006's 'simplified' rules:

- The special annual allowance (SAA) rules came to an end. These had been introduced in April 2009 to limit pension contribution tax relief for high earners.
- The annual allowance was reduced from £255,000 to £50,000 as part of a series of measures to recoup the tax revenue that would otherwise have been lost because of the SAA's abolition. The annual allowance is likely to stay at £50,000 until at least 2016.
- New 'carry forward' rules began, which mean that subject to certain conditions you can bring forward unused annual allowance from the three previous tax years to set against pension contributions greater than your current tax year's annual allowance.
- The exemption from the annual allowance rules, which applied if you made contributions in the same tax year as drawing benefits, was withdrawn, making last-minute pension planning based on large one-off contributions potentially much less attractive.
- The effective requirement to purchase an annuity or scheme pension at age 75/77 was withdrawn (77 for members who reach their 75th birthday on or after 22 June 2010). There is now no deadline for annuity purchase and you can, if you wish, never draw benefits.
- The framework for income drawdown – drawing income directly from your pension fund – has been revised. In most instances the future maximum you can draw has been reduced and reviews have become more frequent.
- Flexible drawdown now allows you to draw as much of your fund as you wish, provided you satisfy a minimum income requirement, currently set at £20,000 a tax year.
- The flat tax charge on lump sum death benefits from drawdown funds and annuities has increased from 35% to 55%, although the inheritance tax treatment has been relaxed.
- Alternatively secured pensions, which used to be the only alternative to annuities and scheme pensions from age 75/77, have been scrapped.

These reforms have rendered redundant some retirement planning techniques which emerged after 2006. However, they have also opened up new opportunities, both in retirement and estate planning. All of this means that a post-6 April review of your pension planning is now a priority.

The value of tax reliefs depends on your individual circumstances. Tax and pensions laws can change. The FSA does not regulate some forms of estate planning.

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'…there were still a few unexpected announcements…'

Spring Budget changes to the fore

Mr Osborne's second Budget managed to produce a few surprises, in spite of all the changes his first Budget contained.

There was an expectation among some commentators that the Chancellor's second Budget would be a dull affair, as he had set the course for the next five years in his June 2010 'emergency' Budget. However, there were still a few unexpected announcements, alongside results from the many consultations launched last year.

Income tax

The personal allowance rose by £1,000 for 2011/12, to £7,475. The Chancellor promised a smaller rise of £630 next tax year, based on his Budget inflation assumptions. However, the increase in the personal allowance will be matched by a reduction of the same amount in the basic rate limit, so the starting point for higher rate tax will remain unchanged. This follows on from the 2011/12 cut of £1,400 in the 40% tax starting point (i.e. the band decrease of £2,400 less the £1,000 increase in the personal allowance).

Indexation of taxes

From 2012/13, increases to allowances and bands for direct taxes (e.g. income tax, capital gains tax and inheritance tax) will generally be made in line with the consumer prices index (CPI) rather than the retail prices index (RPI).

There will be several exceptions, notably to age-related income tax allowances, but the overall effect is a subtle increase in tax because allowances and bands will probably rise more slowly in the future. For example, over the last ten years to March 2011, the RPI rose by 35%, while the CPI increased by 26.4%.

Company car tax

There was a general company car tax increase for 2011/12, following on from a rise in 2010/11. Alistair Darling announced planned 2012/13 increases in his December 2009 Pre-Budget Report and Mr Osborne did not alter those plans, instead revealing yet another tax rise, this time taking effect in 2013/14.

If you are changing your company car soon, you might find it worthwhile to examine the scales for the next few years.

Individual savings accounts (ISAs)

In his last Budget, Alistair Darling said that the investment limits for ISAs would increase each year in line with the RPI, rounded up to the nearest multiple of £120. The overall ISA limit duly increased to £10,680 from 6 April. Mr Osborne made two announcements on ISAs:

- The basis of indexation will switch from RPI to CPI from 2012/13. This move is again a subtle way of raising revenue: if CPI rather than RPI had applied for 2011/12, the ISA limit would have been £120 lower.
- From autumn 2011, Junior ISAs will be introduced. They will be available to any child under 18 who does not have a child trust fund (CTF) (broadly, those born before 1 September 2002 or after 2 January 2011).

  The proposed maximum investment is £3,000 per tax year, which may be split in any way between a stocks and shares ISA and a cash ISA. The CTF contribution limit, currently £1,200 a year, will be increased to match the Junior ISA.

Entrepreneurs' relief

The lifetime limit for entrepreneurs' relief was doubled to £10 million, with effect from 6 April 2011. Gains up to the limit are taxed at 10%, rather than 18% or 28%. In practice, only a few highly successful entrepreneurs are likely to benefit.

If you sense that the Chancellor was giving nothing away, you may be right. The state of the Government's finances is such that Mr Osborne has no scope for largesse and he is still looking for ways of extracting extra revenue. To save tax, you should look to your own financial plans, not the Chancellor's.

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

Is your individual savings account (ISA) earning 0.5% interest? If you invested in a cash ISA paying 3% interest a little over a year ago, you should check what rate your capital is earning now. Many cash ISAs offering top rates in spring 2010 did so by adding a substantial one-year bonus rate to a low variable rate. Once the bonus falls away, so too does the attractive return. If you don't like your current rate, you can always transfer.

IHT: is it time to give a little?

The Budget announced one helpful future change, but more radical reform could be on the horizon.

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Before last year's election there was talk that the inheritance tax (IHT) nil rate band would be raised to £1 million. During the election campaign this idea gradually moved into the hinterland of 'aspirational' policies. After the election, the formation of the Coalition Government meant that the £1 million goal was abandoned: increasing the personal income tax allowance was given priority over reducing the impact of IHT. The June 2010 'emergency' Budget confirmed that Alistair Darling's planned freeze of the nil rate band at £325,000 until at least April 2015 would be implemented.

The 2011 Budget contained a statement which, on first hearing, seemed to offer some easing of the IHT burden. However, once the details emerged in the many pages of HM Revenue & Customs' briefing notes, it became apparent that this easing was not as generous as it had seemed. What has been proposed is that for wills coming into effect from 6 April 2012, the rate of IHT will be reduced to 36%, provided at least 10% of the taxable estate is left to charity.

This is good news if you are already intending to make substantial charitable donations in your will. If you are now close to the 10% threshold, it could even pay your beneficiaries for you to increase your charitable bequests, once the legislation takes effect. However, if your sole aim is to maximise what your beneficiaries will receive, the concession is of no use, as the example at right shows.

The charitable gift rate reduction may not be the only revision to IHT in the next few years. The Office of Tax Simplification (OTS), which was set up in 2010 by George Osborne, was highly critical of the current IHT regime in its final report, issued shortly before the 2011 Budget. The OTS pointed out that the £3,000 annual exemption had not been increased since 1981, nor had the exemptions for gifts on marriage changed since 1975.

However, rather than simply proposing that these exemptions be uprated, the OTS went much further and suggested that it would be better 'to consider the scope and operation of inheritance tax with reference to the original and desired policy rationale'. The OTS's conclusion was that IHT 'is a tax that needs a 'top down' review'.

The value of tax reliefs depends on your individual circumstances. Tax laws can change. The FSA does not regulate will writing, tax advice and some forms of inheritance tax planning.

Nothing for something?

Alex has an estate of £625,000 when he dies in July 2012. He has a full nil-rate band – still £325,000 – but neither reliefs nor exemptions. He has one beneficiary, his grandson, John.

If Alex's will leaves 10% of his taxable estate to charity, the charity receives (£625,000 - £325,000) × 10% £30,000.

John receives:

Gross estate	£625,000
Charitable gift	(£30,000)
Inheritance tax (£270,000 @ 36%)	(£97,200)
Net estate distributed to John	**£497,800**

If Alex's will leaves everything to John, John receives:

Gross estate	£625,000
Inheritance tax (£300,000 @ 40%)	(£120,000)
Net estate distributed to John	**£505,000**

Could you live on £140 a week?

The Government has finally revealed its thinking on the future of state pensions – and it really is food for thought.

Last autumn, a variety of press reports began to appear suggesting the Government was about to introduce a flat-rate state pension of £140 a week. After nearly six months of such rumours, the Department for Work and Pensions (DWP) published a consultation paper in early April. It was not quite what had been expected, but then the problems the paper addresses are extremely complex.

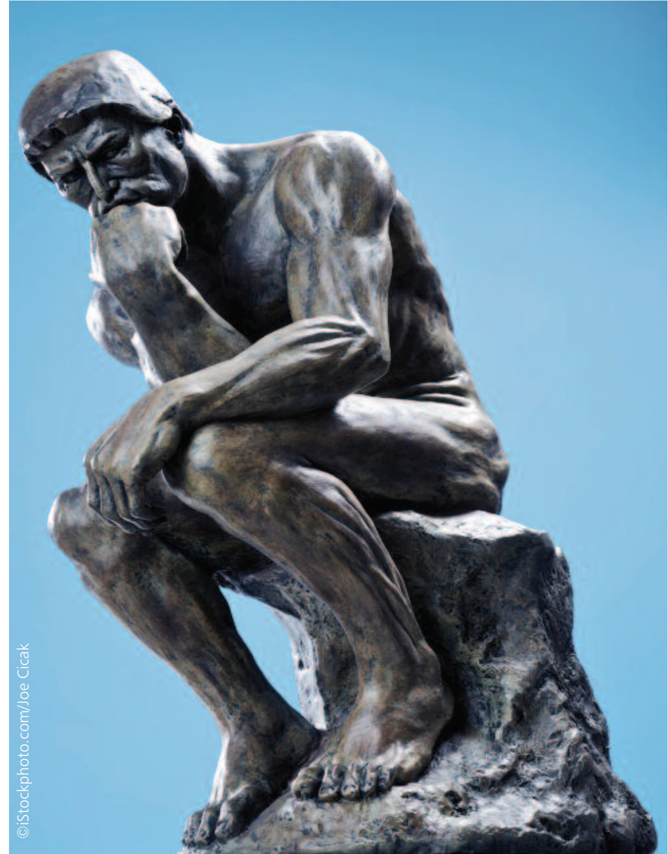
The current state pension regime consists of a basic state pension, a state second pension (S2P), a variety of S2P predecessors and two different types of pension credit. This amalgam has been widely criticised as overly complicated, particularly in its interaction with private pension provision. The situation is likely to get worse from October 2012, with the arrival of quasi-compulsory private pension provision in the form of the new National Employment Savings Trust (NEST) and auto-enrolment into employer pension arrangements.

The DWP puts forward two options in its paper, both of which aim to produce a pension above the level of the pension credit standard minimum guarantee (which is £137.35 a week for a single person in 2011/12):

Option 1 This would see S2P become a flat-rate pension in 2020, a stage it is not currently scheduled to reach until the mid-2030s. Ultimately, someone with a 30-year national insurance contributions (NICs) record would look forward to £145 a week (in current terms) from state pension age, provided by two flat-rate state pensions; the basic state pension and S2P. A longer contribution record would only increase the S2P element. Contracting out of S2P would remain an option for defined benefit occupational pension schemes (it is disappearing for defined contribution arrangements from 2012/13).

Option 2 The paper describes this as 'a more radical approach', but in reality it looks more like the new state pension regime described in the earlier leaks. S2P would be scrapped and there would be one single state pension, calculated on an individual basis, with no special rules for marriage, divorce or bereavement. This option would include the self-employed, who currently accrue only basic state pension. A 30-year NICs record would produce around £140 a week of pension, but any longer contribution record would not yield a greater pension. There would be no benefit for anyone with a NICs record of less than seven years. All contracting out would end, and the savings element of pension credit would disappear for new pensioners.

The second option is probably the DWP's preferred route: some experts have seen the first option as little more than a 'straw man' to help the case for option two. However, creating an affordable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single pension regime raises difficult transitional issues in dealing with existing second tier state pension entitlements and contracted out benefits. The state cannot afford to pay £140 plus all existing S2P and contracted out benefits. In both instances, the paper points to some form of offset, so that, for example, the £140 a week could be a combination of state benefit and the contracted-out element of private provision.

Neither of these proposals will become a reality soon, and indeed may not happen at all. In any event, they are a sobering reminder of the kind of income the consultation paper's authors were considering as an 'adequate' retirement income – could you live on £140 a week? What either proposal should do is establish a base on which to build a private pension, removing the present risk that such provision will simply replace what the state would have paid under pension credit.

This article is based on our understanding of the Government's current position, which is subject to change.

Did you know that, in the March Budget, the Chancellor announced that the Government would be bringing forward 'proposals to manage future increases in the state pension age (SPA) more automatically in response to increases in longevity'? The subsequent Department for Work and Pensions consultation paper on reforming state pensions (see story above), put forward two ideas on how SPA could be adjusted. If you were born after 5 April 1954, your SPA is already at least 66. Existing legislation will raise the SPA to 68 by April 2046, but this is almost certain to be overtaken by the reforms now being considered.

Inflation: a threat to buying power, interest rates – and tax allowances

Inflation has not been within the Bank of England's (BOE's) limits since 2009, and the European Central Bank (ECB) says it is still on the rise. What are the implications for UK savers?

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Buying power down

Inflation is not a problem when economic growth is strong, allowing normal interest rates and enabling savings and wages to keep pace. But a combination of high inflation and stagnant wages as the economy struggles out of the financial crisis means that the purchasing power of the average Briton has been slumping for years now. Research suggests the downward trend preceded the onset of the recession, beginning in 2003, and was merely worsened by it.

What savers need to earn

With inflation climbing, a healthy return on investments is needed to prevent savers losing value in real terms, especially if interest payments are not tax-free. So forget 2% – basic rate taxpayers need to earn more than 5% a year to counter inflation on taxed investments, rising to more than 8% for those paying the top rate of 50%. Avoiding this tax drain is just what individual savings accounts (ISAs) are for.

Missing the target

Even worse, those estimates assume that the BOE will, on average, hit its 2% target but the pace of price increases in the UK is routinely topping this. In the past five years, 2% has been pretty much a floor rather than a target, so part of the problem is that using the 2% forecast is not currently realistic. And while both the core measures of retail and consumer prices, the retail prices index (RPI) and consumer prices index (CPI), fell in March, the BOE expects them to pick up again through 2011, with CPI hitting 4-5% and remaining above target into 2012.

More fiscal drag in future

The normal default basis for indexing income tax and all other direct taxes will be changed from the retail prices index (RPI) to the consumer prices index (CPI). This change will start from 6 April 2012 and matters because it will mean that over the years tax allowances and thresholds will rise more slowly than they would have done.

On average, CPI is reckoned to rise 0.5% a year more slowly than RPI. That is a big difference when the target rate of inflation is just 2%. So in the long term more people stand to pay more income tax at 40%, invest less in ISAs, pay more capital gains tax and more inheritance tax. That's the impact of what economists call 'fiscal drag'.

What about interest rates?

Those of us with debts want interest rates to stay low – those of us with savings would like them to pick up. But the BOE is in a classic 'Catch 22' situation: inflation is certainly rising fast enough to justify a hefty hike in its core rate, but the economic recovery is so fragile that any increase in borrowing costs could hamper gross domestic product growth.

However, UK interest rates tend to be highly correlated with those of Europe, and the ECB has raised rates in the euro region already, so some argue that the UK cannot be far behind. That said, interest-rate futures, which gauge how quickly the City sees the ECB taking action, have been pushing back estimates for the first increase in rates for months now, and no increase is now priced in until December 2011 – if you had looked to the futures market for guidance just three months ago, higher rates were priced in for May.

Inflation rates have big implications for UK savers, and it is vital to incorporate them into financial planning to keep savings from being eroded by higher prices.

Don’t waste the personal allowance

The personal allowance rose by £1,000 in April – it could make sense to use it.

The basic personal allowance is now £7,475, which broadly speaking means that the first £7,475 of your income is not taxed. However, if your income is over £100,000, your personal allowance may be lower, or even zero, because of changes introduced from 2010/11.

If you or your legal partner has insufficient income to cover the personal allowance, it could make good financial sense to rearrange or restructure your investments. The aim should be to put additional income where it is needed.

You need to choose the right investments to maximise your tax savings. For example, shares or dividend-paying funds are not as attractive as deposits or bond funds because dividend tax credits are not repayable, while tax deducted on interest is reclaimable in full by non-taxpayers. If your total income is less than your personal allowance, it will usually be possible to arrange for deposit interest to be paid gross by completing HM Revenue & Customs form R85.

For de facto couples, matters can be more complicated. Transfers of investments will count as gifts, raising the spectre of inheritance tax. There could also be capital gains tax, which does not apply to transfers between married or civil union couples living together.

An interesting swap

John and Ann have a joint investment in corporate bond funds, which together produce interest of £2,000 a year before tax. They also have similarly valued joint holdings in global growth funds, which pay no dividends.

- **At present Ann pays no tax on the corporate bond income, but John, who is a higher rate taxpayer, pays £400.**
- **If the investments were rearranged so that John alone held the global growth funds and Ann alone held the corporate bond funds, both John and Ann would have no income tax to pay – a saving of £400.**

Every child has their own personal allowance, but taking advantage of this is not straightforward. Long-standing anti-avoidance legislation means that if more than £100 of income is generated for a minor unmarried child from capital given by a parent, then the income tax liability falls on the parent. Non-parental gifts, e.g. from grandparents, are not subject to this rule.

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

Test-Achats ECJ decision bites

Belgians, gender and annuities might be an unlikely combination, but it could be important for your retirement income.

In March, the European Court of Justice (ECJ) issued a landmark ruling on a case involving sex equality and insurance premiums brought by a Belgian consumer group, Test-Achats. The question before the judges was whether the exemption from the European Union’s equal treatment rules allowing insurers to calculate sex-based premiums was valid. The ECJ’s decision was that sex equality meant just that and gender-based premiums – whether for car insurance, life cover or anything else – must end. Fortunately, the court did not rule that the change should be immediate, but deferred its implementation until 21 December 2012.

One consequence will be that insurance companies will no longer be able to offer higher annuity rates to men than to women, based on the fact that women live longer. From December 2012 all annuities will have to be on a unisex basis. It is not yet clear what this will mean in practice. Men could find their annuity costs rise to match women’s. If you are a man planning to retire in 2013, you might want to reconsider your plans....

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Protection insurance: the countdown to change begins

Is it different for girls? Not any longer...

You may have heard about the recent European Court of Justice (ECJ) ruling on gender discrimination which means that insurers can no longer charge different rates for men and women (see 'Test-Achats ECJ decision bites' on page 7).

Changes are set to come into place in December 2012 – when we could see higher prices for protection insurance. It might make sense to buy cover before these rises come into force.

The media has focused on the perceived unfairness of the ECJ ruling. To date, insurers have charged men and women different rates according to the risk. It is now believed that where one sex gets a better deal, this will change to create parity. But do not expect any price reductions – insurers are more likely to raise the price of the lower premium.

Most media coverage to date has been of women drivers – they tend to have fewer serious accidents, and so generally get cheaper premiums. Now their rates are set to rise, and protection insurance is also set to become more costly. At present, women pay less for life cover because they live longer, but the Association of British Insurers has said that life insurance rates for women could go up by around 20%.

What about insurance like critical illness? Presently, women pay more for this as they make more claims. It is now expected that these policies are set to become more expensive for men.

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There is another reason why protection insurance is set to become more expensive. The last Budget revealed plans to remove the protection class of business from the 'I minus E' tax regime, which stands for 'Investment return minus Expenses of management'.

Under the current structure, companies with large savings books can use their savings business to offset the expense of protection business, meaning they could offer lower premiums as a result. There is also the impact of the impending Solvency II Directive, which requires insurers to hold more capital to maintain a strong balance sheet. Protection insurance matters – and so does taking the right advice on what is right for your needs. Please contact us to go over your options.

An ISA is not just for March

It is one of the curiosities of personal finance that marketing for individual savings accounts (ISAs) is concentrated at the end of the tax year. The March weekend papers are full of ISA ads and supplements, but by May any trace of ISAs has melted away (excuse the pun).

Logically, the time to invest in ISAs is at the start of the tax year. The sooner you invest, the more time you have to benefit from the tax advantages ISAs have to offer. There is no need to wait for the dying months of the tax year to determine how much you can invest. Even if you cannot make the maximum £10,680 investment now, an early start with some contribution still has financial logic. Bear in mind that up to half of the £10,680 limit can be in cash, and it could make sense to move cash deposits from tax-bearing accounts (up to £5,340) early in the tax year. This would allow you to stop paying income tax on the switched amount.

The value of your investment and the income from it can go down as well as up and you may not get back the full amount you invested. Investing in shares should be regarded as a long-term investment and should fit in with your overall attitude to risk and financial circumstances. The value of tax reliefs depends on your individual circumstances. Tax laws can change.

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