



“Where is the money to come from?”

*Response to the 2009 budget by Anne Redston,
visiting Professor in tax law, King's College, London*

Financial planning considerations from the 2009 budget

Alistair Darling's 2009 speech was probably the most anticipated budget for decades and always promised to be rather short on good news. In fact, as the details emerged in the days following the speech, the response became widely disdainful.

During his 90 minute speech, the Chancellor predicted that the UK economy would shrink by 3.5% in 2009 before recovering sharply to grow by 1.25% in 2010 and 2011. These figures began to look optimistic when it emerged a few days later that UK Gross Domestic Product (GDP) shrank by 1.9% in just the first three months of the year, the sharpest decline in almost 30 years. Indeed, the International Monetary Fund (IMF) does not share the Chancellor's optimism, forecasting a 4.1% drop in output this year followed by a 0.4% fall in 2010.

On the whole, the promised 'austerity' budget failed to materialise and, as Professor Redston observes above, the finances do little to address the Government's huge increase in public borrowing. Income and VAT receipts in April were around £2bn lower than a year ago, while social benefit payments were £1bn higher.

Instead, the Chancellor opted to tinker with the tax system by squeezing the rich. Whilst this may have impressed some voters, it prompted credit ratings agency Standard and Poor's to downgrade its view of the UK to 'negative' (for the very first time) due to the deteriorating state of the public purse and the political uncertainty over how to repair it.

All of which led the Institute for Fiscal Studies to conclude that we face “two parliaments of pain” following “breathtaking” damage to the economy. Damage which the (admittedly right-wing) think-tank estimate as a black hole of £90 billion or, put another way, £2,840 per year in additional taxes for each UK family until 2017-18.

In financial planning terms, the complexity of the new rules, in particular, increased tax rates, the reduction of tax breaks for pensions and extended ISA allowances mean the choice of investment wrapper becomes an even more important part of the financial planning process. This we feel reinforces the need for expert advice to mitigate tax and arrange circumstances in a tax efficient manner.

Higher rate income tax relief on pension contributions

The budget contained provisions to limit the tax relief on pension contributions for 'high income individuals' earning £150,000 or more a year by introducing a charge on contributions above a new annual allowance of £20,000. Any pension payments made by high-income individuals that exceed this allowance and are not otherwise protected, will be subject to a charge intended to effectively limit tax relief on these payments to the basic rate. Payments which do not exceed this amount are not affected.

The 'high income' calculation must include all taxable income including earned income, dividends and salary sacrificed for pension contributions after 22 April. Pension payments may be used to reduce earned income, however the maximum deduction is £20,000. In practice, an individual may earn a gross salary of up to £169,999 before being classed as a high-income individual.

The exact definition of a high-income individual depends on income earned during the applicable tax year and the two preceding tax years, thus some individuals may still qualify as high income individuals even though they may now be basic rate tax payers. This is an absolute threshold and individuals earning just £1 below the maximum will not be affected.

Protection is provided for existing regular pension contributions as long as they continue to be paid to the same scheme. Significantly, the pattern of payments must be as least as frequent as quarterly to qualify and regular annual contributions are excluded.

The legislation specifically includes as income any salary sacrificed in exchange for a pension contribution, unless the arrangement was in place before 22 April 2009. Interestingly, it does not include salary sacrificed for other 'non-cash' benefits. This could potentially include employee benefits such as additional holidays, critical illness insurance or company cars.

Whilst this is not as dramatic as some commentators had predicted it is hardly likely to engender any confidence in pension plans as long terms savings vehicles. The additional complexity means that there is an even greater need than ever for advice. This is particularly so when you consider the potential impact of accelerated income tax measures for those earning more than £100,000 from 2010/2011.

In particular, it is important that advice be sought when:

- Making any changes to established regular contributions, which may be Protected Pension Input Amounts and not subject to the special annual allowance charge.
- Making pension contributions above £20,000 which may attract the special annual allowance charge.
- Switching pension providers. This may result in any protected pension input amounts being lost.
- Considering salary sacrifice benefits which may reduce the income that must be taken into account.
- Deciding the optimum remuneration strategy, for those with the ability to influence the amount and format of their income.

Income Tax

The Chancellor has announced the following changes to income tax rates and allowances for taxpayers with income over £100,000:

- From 2010-11, there will be an additional higher rate of 50 per cent for taxable income above £150,000;
- From 2010-11 the basic personal allowance for income tax will be gradually reduced to nil for individuals with “adjusted net incomes” above £100,000;
- From 2010-11 there will be increases to the trust rate and dividend trust rate to match those for income tax;
- The measure includes new powers to vary the income tax rates for the charges that apply to registered pension schemes.

These changes replace the announcements made at the 2008 Pre-Budget Report. The reduction of personal allowances affects those with incomes over £100,000 and the new tax rate affects those with incomes over £150,000.

This effectively means that personal allowances will be lost in full for those earning around £114,000, with an effective marginal income tax rate of 60% on the income between £100,000 and £114,000.

Trust Income

From 6th April 2010, Trust rates will increase from 32.5% to 42.5% for dividend income and from 40% to 50% for other trust income in line with the top rates of income tax that will apply to high earners. Both of these rates have been increased by 5% from the previous announcements and are to apply a year earlier than previously announced.

The increased rates will apply wherever trust income is in excess of the standard rate band of £1,000: regardless of the fact that it may not be anywhere near the £150,000 limit applicable to high earners.

Where trustee's income does not exceed the standard rate band, it may not be necessary to complete a tax return every year.

The good news is that where the trustees invest in non income producing assets, such as investment bonds, the rates will only apply if a chargeable gain occurs. The unique structure and tax treatment of Life Insurance Investment Bonds have long been considered attractive as investments for trustees as they allow scope for trustees to control the tax point, defer or stagger a tax liability, simplify administration and potentially make tax efficient distributions to beneficiaries.

The benefits of investment bonds as trust investments include:

- ✓ As no liability to income tax arises unless and until a chargeable event occurs, tax deferral is possible and administration is simplified.
- ✓ The fact that the bond is non income producing and can be written on multiple lives, means the trustees have control over the tax point.
- ✓ The ability to withdraw up to 5% of the original investment each year without any immediate liability to income tax gives trustees the potential to make regular 'income' payments or ad-hoc capital distributions to beneficiaries without any adverse income tax consequences.
- ✓ There is no capital gains tax for either the Settlor or the trustees which means that trustees may switch between funds freely and without tax consequences allowing them to easily meet Trustee Act requirements such as the need to diversify and regularly review trust investments.
- ✓ Substantial income tax savings can often be made where policies are assigned out to beneficiaries prior to encashment. Provided the beneficiaries are not themselves higher rate tax payers, any gain will be taxed at a lower rate in the hands of the beneficiaries and it may even be possible for a tax liability to be avoided altogether through the use of top-slicing relief.
- ✓ The Revenue's recent change in stance on the taxation of life policies held in trust for minors means that taking advantage of an absolutely entitled beneficiary's tax position will now be possible even if the beneficiary is a minor (provided that the trust is not caught by parental settlement rules).

Loss making businesses

The budget contained a measure of good news for companies. For loss-making businesses the ability to reclaim tax paid in the last three years has been extended for another year.

For businesses looking to invest in the future, the introduction of an enhanced 40% first year capital allowance is also good news; particularly in light of the continued availability of the Annual Investment Allowance on the first £50,000 spent on plant and machinery.

ISA Allowances

The annual Individual Savings Account (ISA) limit will rise to £10,200 per year for those aged over 50 on 6 October; for all others the new limit will be available from 6 April 2010. This may present an additional opportunity to refine retirement funding plans.

Venture Capital Trusts (VCTs) and Enterprise Investment Schemes (EIS)

The main HMRC approved tax efficient investments schemes are likely to prove even more popular this year, perhaps as a home for previously earmarked pension contributions.

VCT investments of up to £200,000 in any tax-year attract income tax relief at 30% and benefit from tax free gains at realisation as well as tax free dividends which will include distributions of capital realised within the trust.

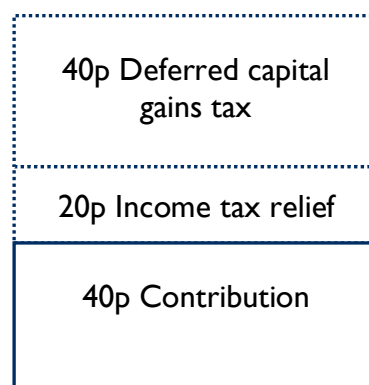
It remains possible to make an in specie contribution of VCT shares to a pension scheme after the initial qualification period for income tax relief has expired

For Enterprise Investment Schemes, the following announcements were made in the budget:

- ✓ The rules surrounding the time period within which EIS monies must be spent has been relaxed, removing the requirement for 80% of funds to be spent within 12 months.
- ✓ The carry back period has been extended to allow the full amount subscribed to be carried back to the previous year.
- ✓ Removal of the restriction on simultaneous non EIS (and therefore unrestricted) fundraising.

Providing that no EIS investment were made in the last tax year it is now possible to obtain income tax relief @ 20% on a contribution of £1m using carry back relief. Other EIS tax benefits remain including tax free gains on realisation.

Where individuals have made taxable gains on other assets, combined income tax relief and capital gains tax deferral may reduce the effective “net” contribution to an EIS to just 40p in the pound.



We hope that the information in this note is useful. The management of significant assets brings with it a host of complex issues and when formulating a strategy it is important to consider all of the viable options and their potential consequences. The world of finance moves at a rapid pace and we recognise that many affluent investors need sophisticated advice and strategic guidance to preserve, grow and transfer their wealth as efficiently and fruitfully as possible.

Please do not hesitate to contact us if you would like to discuss the issues raised, or indeed any other matter.

Important Note: PFP has made this document available for your general information. You are encouraged to seek advice before acting on the information, either from your usual adviser or ourselves. We have taken all reasonable steps to ensure the content is correct at the time of publication, but may have condensed the source material. Any views expressed or interpretations given are those of the author. Please note that PFP is not responsible for the contents or reliability of any websites or blogs and linking to them should not be considered as an endorsement of any kind. We have no control over the availability of linked pages. © PFP Group - no part of this document may be reproduced without the express permission of PFP. PFP Wealth Planning is authorised and regulated by the Financial Services Authority, registered number 473706. 1040/09/SB