# Osborne attempts to increase household BUDGET?

Welcome to our latest Technical bulletin which follows swiftly on from the March budget delivered by George Osborne. This bulletin provides you with an update of the basic tax allowances available to you from 6 April and in greater detail some potential tax planning opportunities in relation to investments and pensions.

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## UPDATE OF PERSONAL TAX ALLOWANCES

***Income tax:***

The personal allowance, the amount at which individuals pay no tax on their earned income, has been increased from £8,105 in 2012/13 to £9,440 in 2013/14. The Government has confirmed in the Budget that the personal allowance will increase to £10,000 in 2014/15 which has been a policy fought hard by the Liberals. Those individuals born between 6th April 1938 and 5th April 1948 will have their personal allowance held at £10,500 from 6th April 2013 and for those individuals born before 6th April 1938 will have their personal allowance held at £10,660.

The basic rate 20% income tax band above the personal allowance has seen a reduction from 6th April 2013 from £34,370 to £32,010. Individuals will remain basic rate tax payers if their total taxable income remains below £41,450. Taxable income over these amounts but under £150,000 will be subject to 40% income tax. Any income over £150,000 for the tax year will be subject to the highest rate 45% income tax – this is a reduction from the previous 50% income tax rate.

Your personal allowance is reduced by £2 for every £1 over £100,000. Therefore any income over £118,880 will mean that your full personal allowance will be lost.

***Capital gains tax:***

The capital gains tax annual exemption for each individual will increase from 6th April 2013 from £10,600 to £10,900. The rates of capital gains tax have remain unchanged following the budget with basic rate tax payers paying 18% and higher rate tax payers paying 28%.

Any unused losses from previous years can continue to be carried forward to be used against future capital gains above an individuals annual exemption.

***Inheritance tax:***

The nil rate band, the amount to which no inheritance tax is payable on the estate following death of an individual, continues to remain at a rate of £325,000. The inheritance tax rate payable is 40% and this rate has been frozen until 2017/18. Any assets passing to a spouse on death will not form part of this nil rate band. If assets pass to the spouse on death there is a facility where the spouse will inherit any unused nil rate band of his/her late partner meaning her nil rate band on death increases to a maximum of £650,000.

***National Insurance:***

**Class 1**: Employees earning less than £149 per week (£7,748 per annum) from 6th April 2013 will pay no National Insurance on their salary. Those earnings between £149.01 and £770 per week (between £7,748 and £40,040 per annum) will pay 12% on their income and any income over £770 per week will incur National Insurance at 2%.

Employers will pay 13.8% on employees' salary over £148 per week (£7,696 per annum).

**Class 2**: National Insurance is a flat rate of £2.70 per week with the small earnings exception at £5,725.

**Class 3**: Voluntary contribution rate is now £13.55 per week.

**Class 4:** Self employed individuals will pay National Insurance at 9% on profits between £7,755 and £41,450 with 2% payable on profits above this level.

***ISA allowance:***

ISAs were introduced on 6th April 1999, replacing the earlier Personal Equity Plans (PEPs) and Tax-Exempt Special Savings Accounts (TESSAs), which continued to exist only for money already invested in them and for interplan transfers.

An ISA can contain two components:

1. A cash component: a cash deposit that is similar to any other ordinary savings account, apart from the tax-free status.

2. A stocks and shares component: the money is invested in 'qualifying investments' consisting of any combination of stock market equity investments (with no geographic restriction), public debt securities such as government or corporate bonds, or cash "awaiting investment". As a consequence, the risk profile of the ISA may be anything from low to high and there is the potential for capital losses. The investments may also include or consist of property funds or derivatives such as options. This element may be self-invested and managed through a stockbroker, but the majority of investors invest collectively through a collective investment such as a unit trust, OEIC or investment trust.

An article later in this bulletin details an addition to the qualifying investments within an ISA to include shares in smaller companies which can qualify for 100% Business Property Relief and therefore potential inheritance tax savings. This addition is currently under consultation by the Government.

The maximum investment into an ISA in a tax year will increase from 6th April 2013 from £11,280 to £11,520. Half of this allowance can be invested into a Cash ISA as a maximum. You can only invest into one Cash ISA and one Stocks and Shares ISA in a single tax year.

Every individual will have different circumstances and objectives, and therefore tax planning is likely to be different from one individual to another. We tailor our advice to help individuals meet their needs and objectives. If you require tax planning advice please do not hesitate to contact us.

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## At a glance following the Budget Review - VCT, EIS and BPR

**VCT**

The one and only change concerning VCT's within the budget is their ability to initiate Enhanced Buy Backs. Once you have held onto the shares for a qualifying period (usually 5 years), the company may purchase the shares off you, and then offer you new shares which would qualify for further relief in line with the legislation at that time. The government believe that this is not 'within the spirit of the law' and it has instructed the Treasury to 'monitor' this situation.

A Venture Capital Trust is a tax efficient investment scheme designed to provide private equity for small expanding companies. A VCT has many benefits which include:

- Income tax relief at 30% on the amount invested into the shares, up to £200,000 if they are held for at least 5 years
- Exemption from Income Tax on the dividends of the ordinary shares
- Exemption from Capital Gains Tax on disposal

Bottom up growth is one way in which the government can kick start the economy and with banks still reluctant to lend to new businesses, George Osborne has not changed the significant tax advantages of investing into Venture Capital Trusts.

However it is worth noting that VCTs are high risk investments and there may be no market for the shares should you wish to dispose of them. You may lose your capital.

**Enterprise Investment Schemes (EIS)**

Similar to the VCT rules, the government have made no changes to the attractive tax incentives of investing into these schemes. The government confirmed that capped income relief does not apply to EIS share loss relief.

The Enterprise Investment Scheme is designed to encourage investments in small unquoted companies trading in the UK. To encourage growth of small companies, the government had previously put in place significant tax incentives for investing:

- Income Tax Relief of 30% on EIS investments of up to £1 million per annum
- Deferrals of capital gains realised on other assets
- Exemption from Capital Gains Tax on disposal after three years
- EIS investments are exempt from Inheritance Tax after two years of holding, subject to the company being allowable

**SEIS**

The Seed Enterprise Investment Scheme was launched in the 2012 budget, it targets small, early-stage companies with the aim being to stimulate entrepreneurship and kick start the economy. A SEIS scheme has some very attractive incentives for investing:

- Investors can receive up to 50% tax relief on up to a £100,000 investment in the tax year the investment is made
- Taxpayers can roll a chargeable gain on the disposal of assets in the tax year in to shares qualifying for SEIS income relief, with full Capital Gains Tax Exemption

The government has extended the Capital Gains Tax relief, but has reduced it to 50%. The government had decided that a limited extension of the CGT holiday will encourage investors to take up the new scheme.

Enterprise Investment Schemes (EISs) and Seed Enterprise Investment Schemes (SEIS) are very high-risk investments. An EIS/SEIS investment is usually concentrated in one single unquoted trading company. Often there is no market for the shares and it may therefore be very difficult to make a disposal. There is a strong possibility of the chosen company failing"

**IHT/BPR portfolios**

In the UK, it is possible to reduce inheritance tax by holding some types of property used for business purposes e.g. shares in unquoted companies.

The Chancellor has announced he is going to scrap the Stamp Duty Reserve Tax associated with UK funds, on growth markets such as the AIM. The 0.5% duty is paid by the fund manager rather than the investor, which makes BPR portfolios more expensive to operate. This is a positive step forward in encouraging investment in the country's smallest businesses, and we believe that the cost of such offerings should now be reduced.

The government has continued to break its promise concerning the inheritance tax nil rate band, and it remains frozen at £325,000 until April 2017. If the government's new share equity scheme is successful, this will kick start the housing market and prices could be driven up higher. Whilst this is positive from a home owner's point of view, the freezing of the nil rate band could be seen as a real term 'cut' for the next four years.

The tax treatment depends on the individual circumstances of each client and may be subject to change in future.

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**Fancy that – Income tax, Capital Gains tax and now Inheritance tax relief for ISAs!**

An Individual Savings Account (ISA) is a savings account within which all interest, dividends (except the 10% tax credit) and capital gains that arise are tax-free. There are two types of ISA; cash ISA and a stocks and shares ISA. The limit on how much you can invest each year increased from 6th April 2013 to £11,520, of which £5,760 can be invested through a cash ISA.

The Chancellor announced through his 2012 autumn statement that the Government would consult on expanding the list of qualifying investments for stocks and shares ISAs to include shares traded on small and medium-sized enterprise (SME) equity markets such as the Alternative Investment Market (AIM).

The objective of this autumn statement announcement was to provide access to finance for smaller growing companies which they believe is key to promoting private investment and delivering a sustainable economic recovery.

At present the assets that can be held in a stocks and shares ISA must be officially listed on a recognised stock exchange, in addition to meeting certain other criteria.

Many smaller companies are not listed on the Financial Services Authority Official list, or are not listed in a qualifying country outside of the UK, and are therefore ineligible to be held within an ISA at this time. The announcement from the Government is likely to change this.

Many of the smaller company shares being targeted by this policy are eligible for tax reliefs for unlisted shares, such as Enterprise Investment Schemes (EIS) and Business Property Relief portfolios (BPR). One of the eligibility requirements for these tax reliefs is that the shares are not listed on a recognised stock exchange.

This means that the company shares that would newly qualify to be held in stocks and shares ISAs under the proposed expanded criteria would not lose their eligibility for these tax reliefs, so long as the shares remained unlisted.

This could present an interesting tax planning exercise for investors who have an objective to preserve as much wealth built up over their lifetime to pass to their children and dependants, and those who have larger ISA portfolios.

As detailed in the previous article Business Property Relief portfolios and EIS investments attract inheritance tax relief if the investments are held at date of death, have been held for more than 2 years and at that time are still eligible for Business Property Relief.

The table below provides the level of inheritance tax payable on a £100,000 ISA portfolio held within an investor's estate (assuming the total value of the estate exceeds the nil rate band, currently £325,000 and potentially double this for married couples/civil partners, and the entire ISA portfolio is subject to Inheritance Tax) and also compares the effects this new policy will have on that same ISA portfolio if it is invested into smaller company AIM shares which benefit from Inheritance tax relief after 2 years: -

| | **Current ISA portfolio** | **ISA with AIM shares** |
|---|---|---|
| Current Value | £100,000 | £100,000 |
| **Inheritance tax liability (if held for less than 2 years)** | **£40,000** | **£40,000** |
| **Inheritance tax liability (if held for more than 2 years)** | **£40,000** | **£0** |

Please note that while there are benefits to increasing the investments eligible for holding through an ISA by including less mainstream investments there are additional risks and therefore risk of capital losses. Shares in smaller companies carry very high risks of volatility and therefore these investments should only be suitable for those investors who understand and accept the levels of risks involved.

Assuming this policy is legislated for by Government it may be prudent for the older generation who hold significant monies in UK Equities within a stocks and shares ISA portfolio and who have an inheritance tax liability to take financial advice. Investing into UK smaller companies within the ISA portfolio rather than mainstream UK Equity funds will still provide investors with performance linked to UK stock markets but investors will also receive the added benefit of inheritance tax savings if the portfolio is held for 2 years following the smaller company shares purchases.

*Please note that the Financial Services Authority does not regulate tax advice and the tax treatment of investments depends on the individual circumstances of each client and may be subject to change in future.*

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## CON-demnation of pensions?

Many of you are likely to have read in the financial press following last year's autumn statement, the changes that were planned for both pension saving and taking pension income. This article will recap on these changes and also provide some potential planning points for some individuals.

*Annual allowance*

The annual allowance will be cut further from £50,000 to £40,000 with effect from 6th April 2014. This is a far cry from the annual allowance of just a few years ago, with it having stood at £255,000 in 2010/11. Any contributions in excess of this amount will attract a tax charge at your highest rate of income tax, and it is also important to remember that any increases in accrued benefits due to active membership of final salary schemes will also count towards this allowance.

There are some tools available which will allow you to make higher contributions in certain circumstances. Any unused allowance from the previous three tax years can be carried forward, thus enabling individuals to make a one-off, increased contribution. However, the level of contribution must not exceed your earned income for that tax year. Alternatively, an employer could make the increased contribution on your behalf so long as it can be justified as a reasonable business expense.

For some high net worth investors with a high appetite for risk and a high level of taxable income, these further cuts to the effectiveness of pension building might increase the attractiveness of Enterprise Investment Schemes (EIS). These schemes will be able to provide relief from income tax (and possibly capital gains and inheritance tax), whilst also providing an attractive level of tax-efficient income in some cases.

However, they will certainly not be suitable for everyone due to the very high level of risk involved. An EIS is usually concentrated in one single unquoted trading company. Often there is no market for the shares and it may therefore be very difficult to make a disposal. There is a strong possibility of the chosen company failing.

*Lifetime allowance*

Similar cuts are scheduled for the lifetime allowance too from 6th April 2014, when the maximum penalty-free limit will be reduced yet again from £1.5 million to £1.25 million, having stood at £1.8 million as recently as the 2011/12 tax year. So much for encouraging the UK to save for their retirement and reduce the burden on the state! Any excess above this limit is taxed at 55% if taken as a lump sum, or 25% (before then paying income tax on top) if taken as income.

Here, there is very little that can be done other than protecting your lifetime allowance at its existing level if necessary. If no previous protection exists, it is possible to protect your lifetime allowance at £1.5 million on the basis that no further benefit accrual then takes place (i.e. no more contributions, and no more added years in your final salary schemes).

There is likely to be another form of protection available for individuals who already have a fund above £1.25 million but wish to continue making contributions, although the maximum limit will still remain fixed at £1.5 million.

The key points to consider here as far as we are concerned are whether pension contributions remain a viable planning point for some younger individuals with already substantial funds. Certainly, we might advocate suspending any regular contributions currently being made and look to review whether lump sum contributions are appropriate once or twice a year.

There is another factor to consider for those who are close to retirement and that is - when to draw your benefits? In certain cases drawing retirement benefits before 6th April 2014 could result in a tax saving, if your pensions savings are valued between £1.25 million and £1.5 million and you are unable to register for protection against the reduced lifetime allowance (for example, if you are an active member of a final salary scheme).

*Capped drawdown*

Many pensioners were hit by the triple whammy of low gilt yields, poor investment returns and a reduction in the maximum level of income from 120% of the Government Actuary’s Department (GAD) maximum, to 100%. These factors all contributed to falls in the maximum levels of income available.

Fortunately, there has been a U-turn of sorts with the government allowing the maximum income to revert back to 120%. However, this will be of more benefit to some than others and the full scale of the benefit will depend upon the dates your ‘policy year’ runs between. In the best case scenario, the increase will apply almost immediately. In the worst case scenario, you may have to wait almost twelve months to benefit from any increase.

We propose to deal with each case at your scheduled review dates, however, if you would like to know your individual position before then, please do get in touch.

*Flexible drawdown*

The rules for flexible drawdown remain unchanged. Individuals with guaranteed pension income of at least £20,000 gross each year, are able to ‘raid’ their drawdown funds without reference to any upper limit. It does need to be borne in mind that any further pension contributions or benefit accrual in final salary schemes made in a tax year after flexible drawdown has been granted will result in tax charges on the total amount of the contributions/accrual.

Flexible drawdown does open up some potential inheritance tax planning opportunities for those individuals aged below 75. It is possible to take retirement benefits from certain segments of your pension fund and draw out the entire segment, 25% of which is tax free, whilst leaving a large proportion of the fund ‘unvested’. Unvested pension funds are free from tax upon death before age 75 and can therefore pass to future generations without suffering any taxation, whereas funds in drawdown are subject to a 55% tax charge on death at any age.

*Spousal bypass trust*

Some of our married clients have been making use of ‘spousal bypass trusts’ to receive their unvested pension funds in the event of untimely death. Establishing such a trust to receive pension funds upon first death ensures that the funds are not subject to inheritance tax upon subsequent death of the surviving spouse. We ask our clients to note however, that HMRC are scrutinising the facility to loan the funds in a spousal bi-pass trust back to the survivor. This curtailed facility might well reduce the attraction of these arrangements for many.

Such planning tools can be effective where there are significant other assets to call upon for the surviving spouse and where a couple’s estate upon second death is likely to exceed £650,000, although a surviving spouse could gain access to the trust capital if required.

If this is of interest to you please let us know, and we will be able to refer you to a suitably qualified specialist in this field.

Indeed, if you would like to discuss any of the points raised above in greater depth please do not hesitate to contact us.

*The tax treatment depends on the individual circumstances of each client and may be subject to change in future.*

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