The Red House

2009 BUDGET PROPOSALS – THE RED HOUSE VIEW

Introduction

In this note we do not go through the proposals in detail. Most clients and connections will receive the usual excellent bulletins from their accountants and lawyers. Our intention here is to highlight what we consider to be the main planning points that arise for our client demographic.

Overview

Unlike Gareth's successful winning tip for the Grand National it gave us no pleasure to be correct in the note sent to clients before the Budget warning of a threat to higher rate tax relief for pension contributions. It was a relief that our other concern over the continuation of the 18% capital gains tax rate was, for the moment, unfounded.

The Budget proposals appeared to starkly divide our clients into winners and losers. The winners are those who are in retirement, managing their investments for a secure future, often with substantial pension funds, ISA, and other investment portfolios. The increase in the annual ISA allowance and the retention of an 18% capital gains tax rate provides useful savings and tax planning options. There are also planning opportunities around transfers of assets between spouses/partners and equalising incomes.

However for TRH clients still in the accumulation phase of their lives, mostly running their own businesses, senior executives, or partners in professional firms, the proposals make depressing reading. One wonders whom the government expects to lead the recovery that is so key to their economic plans. For clients in this position we need to consider the effect of:

- The phased withdrawal of personal allowances on earnings over £100,000 from 6th April 2010.
- The new 50% income tax rate (42.5% on dividends) on income over £150,000, again from 6th April 2010.
- The tapered withdrawal of higher rate tax relief on pensions for those earning between £150,000 and £180,000 from 6 April 2011.
- The complex transitional provisions designed to stop higher rate tax payers maximising pension contributions from Budget day this year.

Main planning points

1. Income tax and personal allowances

We will be looking very carefully at planning opportunities with our clients' income at the various thresholds as follows:

- This year's personal allowance of £6,475
- This year's higher rate tax threshold of £37,400
- The 50% tax threshold of £150,000 from the tax year 2010/2011

The planning considerations will include:

- The transferring of investments between spouses to utilise the above thresholds effectively

- Business owners employing spouses and providing pensions

- Arranging investment portfolios to produce capital gains rather than income

- Reducing taxable income by offsetting pension contributions against earned income (with care, as HMRC will be monitoring these actions)

- Looking closely with our employed clients and their accountants at the balance between taking salaries and/or dividends.

2. Capital gains tax

The retention of an 18% capital gains tax rate is welcome although with the size of the national debt that now needs servicing one wonders how long the differential between this rate and the 40% and 50% income tax rates will last. The annual exemption for individuals is now £10,100 for this tax year.

Planning opportunities that arise include:

- Ensuring both spouses has sufficient assets to use their individual annual allowances.

- Structuring portfolios to achieve gains taxable at 18% rather than income taxable at 40% or 50%

- Taking capital gains to support personal cash flow requirements rather than income

- Advancing planned gains on legacy investments where possible to ensure they are realised at the current known 18% tax rate.

3. ISAs

From 6 October 2009 the maximum contribution for those over age 50 is raised to £10,200 and this level will apply to all investors from the 2010/11 tax year. This is a welcome increase as ISAs are now even more attractive to TRH clients who will be liable for the higher rates of tax. The new level means that we can build up an investment portfolio at £20,400 a year for a couple that is free of income and capital gains tax. For some clients ISAs could well become the preferred choice before pensions for the reasons set out in 4 below. We will be contacting all our clients to ensure, where appropriate, the ISA allowances are fully utilised.

4. Pensions

The headline news was as depressing as expected with tax relief restricted from 6 April 2011 for those with taxable income over £150,000 or more. Relief is tapered so that over £180,000 of income it will reduce to 20%. There is no detail as to how this tapering will work as yet.

But the known detail is even more depressing for TRH clients who are still building up their pension fund. To stop higher rate tax payers topping up their pensions before April 2011, transitional provisions were brought into effect immediately that restricts the opportunity to make sizeable contributions from Budget Day 22 April 2009. These provisions are complex but in brief apply if:

- Taxable income is over £150,000 in this and the last two tax years
- The total pension contributions exceed £20,000 a year
- A change is made to the normal pattern of ‘regular’ contributions

If the above conditions apply, contributions over £20,000 will be subject to a tax charge that reduces the tax relief to the basic rate, except for ‘regular’ contributions that can exceed £20,000. The definition of ‘regular’ could cause the greatest difficulty to TRH clients as ‘regular’ is stated to be quarterly or more frequently and paid for the last two years. So the business owner or self employed professional that often make large annual contributions when profits are known will be caught by this. We will be discussing these changes in detail with all clients who are directly affected. The provisions that apply to higher paid employees in final salary schemes are difficult to understand and are going to require very complex legislation on which consultation is promised! Hopefully, the fog will clear in time for clients with these arrangements to make sensible planning decisions.

The Chancellor announced these changes as being fair to all. This is too simplistic as it shows a misunderstanding of how pension’s taxation works. Tax relief on contributions is not a tax saving, it is a tax deferral. Relief is obtained on monies going into a pension but investors are then taxed at their highest rate on income taken from the plan (apart from the tax free cash). Therefore the higher rate tax payer who expects to remain so in retirement could potentially be getting relief at only 20% now in exchange for income being taxed at 50% in retirement.

We will be looking carefully at each client's current tax position to see whether pension contributions continue to be an effective way of saving in the future. As mentioned above, savings via ISAs, although not tax relievable on the way in, do produce tax free income and capital gains. Portfolios of collectives can be used to maximise annual CGT allowances and then also take gains at the current 18% tax rate.

Conclusions

We would normally try and resist letting politics slip into a note such as this but on this occasion have to say that these proposals are the latest in a history of mismanaged pension's policy from successive Labour Governments since 1997. They are almost too complicated to understand and we believe will lead to poorer retirement provision for all. They also seem to be more political than economic at time when we need careful and sound economic policies to help recovery. Consider the following:-

- Since Labour came to power in 1997 there have been more pensions' ministers than years of government.
- In Gordon Brown's first Budget he removed the dividend tax credit enjoyed by pension schemes which has taken £billions from the value of these schemes over the past 12 years.
- The UK has moved from having one of the most admired and well funded private pensions sector to having one of the worst in Europe.
- Successive legislative changes have made pensions regulations almost impenetrable and increased administrative and advisory costs.

The above are just a few of the changes that have damaged the structure of UK pensions.

There was however some relief from the gloom that spread out from Westminster last week. The FTSE 100 rose by over 1% on the week and is now 20.09% up since the 52 week low of 09/03/2009. Other major equity markets have also been showing some remarkable short term returns as follows –

Index	**52 week low**	**change to 24/04/09**
FTSE Europe ex UK	09/03/09	+35.82%
S & P 500 (USA)	06/03/09	+29.91%
FT Japan	12/03/09	+20.10%
FT Asia Pacific	10/03/09	+27.88%
FT Emerging index	28/10/08	+46.55%

(*All Market data sourced from FT.com/marketsdata/equities 26/03/09*)

We have been reviewing some very interesting academic research that demonstrates the divergence between equity returns and economic performance with a consistency of positive equity returns during recessions. Whilst we are not saying that the above returns indicate a market recovery we do believe that our investment philosophy will deliver our clients the best chance of benefiting from the recovery when it comes. More detail on this in an upcoming investment note.

As can be seen from the above comments, this Budget has created a number of planning considerations for TRH clients. We will be in touch with each client on an individual basis to review your position as part of our normal annual planning service. If, in the in the meantime, there are any immediate questions on this note or any other aspect of the Budget that gives concern please do get in touch.

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The Red House
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