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Growing & Preserving Wealth

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THE SUMMER BUDGET

2015 has been a year of Budgets, just as 2010 was. The clustering of Budgets is a consequence of the introduction of fixed five-year parliaments, with a May election date leading to a Spring Budget that is first and foremost a party political presentation. Any controversial proposals are either left unmentioned or announced with legislation deferred until the new Parliament begins work.

Mr Osborne's July performance certainly had its fair share of post-election surprises, as we explain below.

Income Tax

The Chancellor had already addressed a variety of future income tax changes in March, but four months later he decided to amend some of his Spring thoughts and then add a major reform.

In the first 2015 Budget Mr Osborne said that the personal allowance would increase to £10,800 for *next* tax year (2016/17) and to £11,000 for 2017/18, both changes which made it into the Finance Act 2015. In July he added another £200 to both figures, so that next year's personal allowance will be £11,000 and 2017/18's, £11,200. There is still a long way to go to reach the goal of a £12,500 personal allowance Mr Osborne repeated in his speech.

The basic rate tax band was also given a small boost over the March announcement levels: both the 2016/17 and 2017/18 basic rate bands had another £100 added to them. The end result is that by 2017/18 the higher rate tax threshold will be £43,600, still £275 below the peak it reached in 2009/10. Again there is a good way to travel to Mr Osborne's target of a £50,000 threshold.

The big Budget surprise was a revision to the tax treatment of dividends, which will take effect from 6 April 2016. From next tax year every taxpayer will be entitled to a £5,000 dividend allowance: you will pay no tax on the first £5,000 of dividends you receive, regardless of your marginal tax rate. Thereafter the tax charged on your dividends is 7.5% *higher* than currently applies (see table below).

Marginal income tax rate	**Tax rate on net dividend**	
	2015/16	**2016/17 (above Dividend Allowance)**
Nil	0%	0%
Basic	0%	7.5%
Higher	25%	32.5%
Additional	30.6%	38.1%

To complicate matters further, today's arcane rules which deem any dividend to be paid with a non-reclaimable 10% tax credit will be scrapped. So whereas today a £90 dividend is regarded as £100 of gross income (£90 + £10 tax credit) for tax calculation purposes, from next tax year the same £90 dividend will be treated as £90 gross income. That could be useful if you are bumping into tax thresholds, eg the £50,000 point at which child benefit starts to be taxed.

At first sight this reform looks like a tax cut and, as the Chancellor said in his speech, "85% of those who receive dividends will see no change or be better off. Over a million people will see their tax cut." However, there will be losers from the changes – the Exchequer will *gain* about £2bn a year overall in the longer term. You could be one of those unfortunate extra tax contributors if:

- You have a substantial investment portfolio, producing dividends of more than:
  - £5,000 if you are a basic rate taxpayer; or
  - £21,667 if you are a higher rate taxpayer; or
  - £25,250 if you are an additional rate taxpayer.
- You are a private company shareholder/director who draws your income mainly as dividends rather than salary and/or bonuses, thereby avoiding National Insurance contributions.

It is clearly the latter category the Chancellor had in his sights as the Budget background paperwork made reference to the dividend changes reducing "tax motivated incorporation".

One short-term consequence of the measures is likely to be a bringing forward of dividends into 2015/16 that would otherwise have been payable after 5 April 2016, just as happened ahead of the introduction of 50% tax. The Treasury not only expects this, but is looking forward to it, as it reckons the acceleration in dividend payments will boost tax revenue.

Inheritance Tax (IHT)

The Conservative manifesto promised a main residence IHT nil rate band of £175,000 for homes left to children/grandchildren. The proposal was criticised by experts for its complexity – and that was before details emerged in the Summer Budget. For a start, the new additional nil rate band will not begin until 6 April 2017 and will then be at the level of £100,000. It will subsequently rise by £25,000 each tax year for three years, reaching the £175,000 figure only in 2020/21.

For those with estates above £2,000,000 the band will be reduced by £1 for each £2 above that threshold, so it will eventually disappear completely for estates worth more than £2.35m. There will be rules allowing the new band to be transferred between spouses and civil partners in the same way as the main nil rate band, meaning that if everything is left to the survivor, then on second death in 2020/21 that person's estate could benefit from four nil rate bands totalling up to £1,000,000.

The government will be consulting on how to deal with people who trade down to a smaller home or move into care – a further complication. As the Institute for Fiscal Studies noted, it would have been "much simpler and arguably fairer" – and only a little more expensive – just to increase the nil rate band to £500,000.

Alongside the new main residence band came another nil rate band announcement, but one not trailed in the election manifesto: the main nil rate band is to be frozen for another three years, meaning it will not change before April 2021. As the nil rate band reached its current level of £325,000 in April 2009, that implies an eleven year freeze, negating a large part of the benefit of the new main residence nil rate band.

Pensions

The Budget reconfirmed March's announcement that the lifetime allowance - effectively the maximum tax-efficient value of pension benefits – would be cut by 20% to £1 million from 2016/17, the third cut in four years. It also introduced another cut in the annual allowance – the maximum effective tax-relieved annual contribution – for anyone with:

- "Adjusted income" (broadly all income including their own and their employer's pension contributions) of more than £150,000; *and*

- "Threshold income" (broadly all income excluding pension contributions) of more than £110,000.

The cut takes the form of a reduction in the annual allowance from 2016/17 of £1 for each £2 of 'adjusted income" above £150,000, subject to a minimum allowance of £10,000. This latest attack on the annual allowance was accompanied by a revision to the rules on the arcane subject of pension input periods (PIPs). This will make life easier for most people, but it will also end the opportunities to maximise contributions by manipulating PIPs. Unannounced in the Budget, but later revealed in the Finance Bill, was a set of anti-avoidance measures designed to stop income being shifted between tax years in an effort to avoid breaching the new £110,000 and £150,000 thresholds.

As if that were not enough tax-driven pension reform, in addition alongside the Budget the Chancellor published a brief consultation paper examining tax incentives for saving. The paper was light on detail, but did float the idea of switching from the current pension tax system of tax relieving contributions but taxing most benefits to an ISA-type of arrangement with no tax relief on contributions, but also no tax on benefits. In the short term such a reversal could transform government finances – the paper notes that "Including relief on both income tax and National Insurance contributions, the government forwent nearly £50 billion in 2013-14". At best it looks likely that relief for pension contributions will be moved to a flat rate, benefiting basic rate taxpayers, but disadvantaging higher and additional rate taxpayers, who currently receive over two thirds of pension tax relief, according to the Treasury.

Buy-to-let

Two significant changes to the tax rules for buy-to-let investors in residential property were revealed in the Budget, both of which will raise extra cash for the Treasury. The wear and tear allowance, which allows anyone letting out furnished property to claim 10% of the rent as an allowance, regardless of the true level of expenditure (if any), will be scrapped from April 2016. In its place will be a new relief based on the actual costs incurred in the replacement of furniture. The following April will see the start of a more important reform, the phasing down of tax relief on finance costs to basic rate by 2020/21. Even without the likely interest rate rises over the coming years, this reform will reduce the appeal of borrowing to purchase buy-to-let property, as the example below shows:

	2015/16	**2020/21**
	£	**£**
Gross rent	12,500	12,500
Agent fees + other expenses	(3,500)	(3,500)
Interest on mortgage	(6,000)	(6,000)
Tax (40% taxpayer)	(1,200)	(2,400)
Net income	**1,800**	**600**

If the interest bill in the above example rises by £750, equivalent to little more than 0.5% on the mortgage rate, then this would reduce net income to nil in 2020/21.

Venture capital trusts (VCTs) and enterprise investment schemes (EISs)

A number of amendments were revealed to the rules for VCTs and EISs, restricting the categories of companies in which these schemes may invest. The full impact of these changes is as yet unclear, not least because they will need EU state aid approval as well as parliamentary approval before they take effect, probably in October 2015. The changes could mean that the 2015/16 year-end crop of VCTs and EISs will be smaller than normal as managers get to grips with the new regime. Some VCTs are already sounding warnings about their automatic dividend reinvestment schemes.

Business taxes

Two more cuts to corporation tax were announced: the rate will drop by 1% to 19% for the 2017 financial year and by another 1% to 18% three years later. These cuts partly explain the dividend reforms as, in isolation, a reduced rate of corporation tax makes running a small business via a company rather than on a self-employed basis more attractive.

From 2016/17 there will also be an increase in the National Insurance contribution employment allowance, reducing Class 1 employer's contributions by £3,000 a year rather than the current £2,000. However, there is a sting in the tail: the allowance will no longer be available for one-man-band companies whose sole employee is the company's director.

The annual investment allowance from 1 January 2016 will be £200,000, a cut from the current £500,000, but more than the £25,000 which would have otherwise applied.

ACTION

The second Budget of 2015 was a radical Budget which alters – and even reverses – some tax planning strategies. It could also be the Budget which marks the beginning of the end of tax relief on pension contributions.

Although many of the changes will not take effect until April 2016 or later, now is the time to start planning. If you believe you could be affected by any of the reforms outlined above, the sooner you talk to us the better. And if you think you are unaffected, you probably need to think again…

LONG-TERM CARE: MORE LONG GRASS

The subject of long-term care has been one which politicians of all parties have regularly kicked into the long grass, primarily because of the potential costs of changing the existing system. There are different rules for the four different parts of the UK, with Scotland's currently the most generous and England's the most costly because of the size of its population.

The English system

The current rules for England mean that anybody with capital of more than £23,250 must meet all their own care fees, although they may be entitled to a £112 a week payment towards nursing care costs. A review set up by the last government in 2010 produced a recommendation of a cap on personally-funded lifetime care costs and a much higher means-testing limit. After some delay, the government broadly followed the report's suggestions, with new measures under the Care Act 2014 to take effect in 2015 and 2016. The most significant, due from April next year, were a lifetime personal cost cap of £72,000 and a new upper means test limit of £118,000.

A Friday in July…

In mid-July the Minister of State for Community and Social Care wrote to the Chair of the Local Government Association to say that both new limits would be put on hold until 2020. In his letter the Minister said "A time of consolidation is not the right moment to be implementing expensive new commitments such as this", even though his party's manifesto had stated "we will cap charges for residential social care from April 2016". Several experts saw the move as a prelude to scrapping the cap and higher limit entirely in a couple of years' time. It cannot have escaped the minister's attention that the National Living Wage, announced in the Summer Budget, would lead to a sharp rise in care home costs.

ACTION

This latest deferral is another reminder of the importance of including potential care costs in your retirement planning and not relying upon the government.

Meeting the costs of Long term care can decimate inheritances: in England the state only pays in full once your total assets are worth less than £14,250. If you want to consider your options – or those of an ageing parent – please contact us.

DEPOSIT PROTECTION CUT

The level of protection for bank and building society deposits has been cut by £10,000 to £75,000, although for existing deposits the change will not take effect until the start of next year.

Blame the EU…

The reason for the cut is down to the European Deposit Guarantee Schemes Directive. This Directive states that every five years non-Eurozone countries have to recalculate their minimum deposit protection limit, setting it at the equivalent in their domestic currency of €100,000, subject to a limited amount of rounding. The pound has strengthened against the euro since the limit was last set in mid-2010, which is good news for Mediterranean holidaymakers, but bad news for depositors, already suffering over half a decade of ultra-low interest rates.

Temporary high balances

At the same time as announcing the cut, the Bank of England introduced a new £1 million, six month protection level for 'temporary high balances'. This is designed to cover circumstances where an account is temporarily holding a large payment, eg an inheritance, pending future investment or expenditure. There is a specified list of events covered, including redundancy and divorce(!).

ACTION

If you have more than £75,000 with one bank (£150,000 for joint accounts), then you may want to consider opening an account with a different bank to retain your deposit protection. Remember different institutions may count as one bank for deposit protection purposes if they share a common banking licence (eg Halifax and Bank of Scotland).

Even though interest rates look set to start rising slowly in 2016, holding large sums on deposit may be unwise. Before going through the money-laundering hoops of opening a new deposit account, make sure you discuss your other options with us.