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MONEY NEWS

June 2016

The Budget is an excellent opportunity to review your financial arrangements. This year is no exception; indeed, given the amount of change taking place from 6 April 2016 – including many changes that were announced last year but only now come into effect - clients have a considerable need for financial advice. The main changes, which will have a considerable impact on investment, pension and other financial planning, are:-

- the reform of dividend taxation;
- the introduction of a personal savings allowance;
- the well-flagged restriction on contributions to and accumulation of funds under registered pension schemes; and
- the attack on the buy-to-let and additional residential property owner.

Not for a long time has there been more of a need for financial advice.

Whilst the Budget included the normal crop of targeted tax-avoidance measures, we intend to concentrate here on the changes that will have more general impact on an adviser's clients. In each case we will look at the impact of the change and any planning opportunities that arise.

Before we do so, let's first look at the highlights in terms of changes and then consider in more detail the changes and planning opportunities of most interest to the various types of client that an adviser will have.

MAIN BUDGET HIGHLIGHTS

- The personal allowance was already scheduled to rise to £11,000 for 2016/17. A further increase of £11,500 will now take place in 2017/18.
- The higher rate threshold for 2016/17 was already scheduled to increase by £615 to £43,000. There will be a further £2,000 increase to £45,000 in 2017/18.
- A cut in the rates of capital gains tax to 20% for higher and additional rate taxpayers and 10% for other taxpayers from 2016/17. However, the current rates of 28% and 18% will continue for gains on residential property and carried interest.
- A new Investors' Relief, similar to Entrepreneurs' Relief, for lifetime gains of up to £10 million on newly issued shares in unlisted trading companies.
- The introduction, from April 2017, of a new Lifetime ISA for the under-40s, with a maximum annual contribution of £4,000 and a 25% government bonus.
- An increase in the main ISA allowance to £20,000 from 2017/18.

INVESTORS AND SAVERS

The Personal Allowance

The personal allowance in 2016/17 will be £11,000 and will increase to £11,500 in 2017/18.

In 2016/17 there will be a near £3,000 gap between the personal allowance and the unchanged £8,060 starting point for National Insurance contributions (NIC). With the UEL increasing in line with the higher rate tax threshold (see below) employees will therefore pay more NICs at 12%. At the other end of the income scale, some taxpayers will have no personal allowance in 2016/17 because their adjusted net income exceeds £122,000, at which point their allowance is tapered to nil.

If a client does not use the personal allowance, they could be paying more tax than necessary. There are several ways to make sure they maximise use of their allowances:

- Choose the right investments: some investments do not allow a reclaim of tax paid while others are designed to give capital gain, not income.

- Couples should consider rebalancing investments so that each has enough income to cover the personal allowance.

- Make sure that, in retirement, clients (and their partners) each have enough pension income. On their own, neither state provision is enough, be it the basic state pension (£119.30 a week in 2016/17) or the new single-tier pension of up to £155.65 a week (for those reaching State Pension Age after 5 April 2016.)

Rates of tax

The higher rate tax threshold is £43,000 in 2016/17. In the 2016 Budget, the government announced that this would increase to £45,000 in 2017/18. While it is expected that this will take more than 500,000 people out of higher rate tax, it will still leave some 4.65m as higher rate taxpayers.

Such people have even more incentive to carry out planning to reduce their income tax exposure and could consider contributions to registered pension plans, tax-efficient reinvestment or transferring assets to a lower taxpaying spouse/civil partner.

Those clients whose income is the band above £100,000, which causes their personal allowance to be cut back, could consider strategies to reduce their adjusted net income and so reinstate some or all of their personal allowance. This could save tax of up to 60%.

Appropriate strategies could include:

- Increasing contributions to registered pension schemes to reduce their adjusted net income.

- Reinvestment in investments that are non-income producing (such as investment bonds) or are geared towards capital growth as compared to producing an income yield.

- Transferring income-producing investments to a lower-income spouse/civil partner.

The Personal Savings Allowance

The personal savings allowance (PSA) came into effect on 6 April 2016 ie. for tax year 2016/17. Broadly speaking, for a person who is a:

- *basic rate taxpayer*, the first £1,000 of savings income will be untaxed;
- *higher rate taxpayer*, the first £500 of savings income will be untaxed;
- *additional rate taxpayer*, there will be no personal savings allowance.

'Savings income' in this instance is primarily bank/building society interest, the non-capital element of an annuity, interest from gilts, interest distributions from corporate bond funds and also includes chargeable event gains made on investment bonds.

Although called an allowance, the PSA is actually a nil rate tax band. This means that it will not reduce income for the purposes of, say, determining whether a person is entitled to the full personal allowance or is caught by the high income child benefit tax charge, so it is not quite as generous as it seems.

Introduction of the PSA means that from 6 April 2016 banks and building societies will no longer deduct tax from interest and neither will National Savings & Investments from those products it currently pays net interest on (such as 65+ bonds). From 2017/18 the removal of the requirement to deduct tax on interest distribution payments will be extended to open-ended investment companies, authorised unit trusts and investment trust companies. Income will be classified as an income distribution if more than 60% of the underlying securities comprise of fixed interest investments. From 6 April 2017, interest under peer-to-peer loan arrangements may also be paid gross.

If one of your clients receives substantial interest income and is married or has a civil partner, it is worth checking that they are both maximising the benefit of the PSA, perhaps by making relevant transfers between them.

The introduction of the PSA also gives rise to the question as to whether people now need to bother to use a cash ISA to secure tax freedom on deposit interest. Generally, it is thought that cash ISAs will still be useful because:

- they enable an investor to build up a completely tax free portfolio (which involves no tax returns);
- they will be even more attractive if interest rates increase in the future;
- cash deposits within an ISA can be converted or transferred into a tax free stocks and shares portfolio at a later date;
- and, of course, additional rate taxpayers get no PSA and so for them the cash ISA is the only way to get tax free interest.

The Dividend Allowance

The dividend allowance was a surprise announcement in last year's Summer Budget and also began in 2016/17. It is part of a reform of dividend taxation, ultimately designed to raise more revenue. The main target is private company shareholders who use dividends rather than salary to extract profits from the company and thereby avoid National Insurance contributions.

The allowance will mean that the first £5,000 of dividends an individual receives in a tax year will not be subject to tax, regardless of their marginal tax rate. Once the £5,000 allowance is exceeded, there is a higher tax charge than in 2015/16, as the table below shows, so an investor could ultimately pay more tax on dividend income, in spite of the new allowance. The existing 10% dividend tax credit has disappeared from 6 April 2016, so those rates in the table for 2016/17 are the rates that will be paid.

Marginal tax rate	**Tax on dividend received**		**More tax payable in 2016/17 if total dividends exceed**
	2015/16	**2016/17***	
Basic	0%	7.5%	£5,000
Higher	25%	32.5%	£21,667
Additional	30.56%	38.10%	£25,250

** Above £5,000 dividend allowance on which 0% is chargeable*

Like the personal savings allowance, the dividend allowance is in reality a nil rate band, so up to £5,000 of dividends will not disappear from tax calculations, even though they are taxed at 0%. This means that all dividends will count to determine the level of income a person has for the purposes of, say, the high income child benefit tax charge at £50,000 and entitlement to the personal allowance at £100,000.

(a) Investors

Given that all people qualify for a dividend allowance – irrespective of income – it makes complete sense for both of a couple to make maximum use of it. Where one partner has dividend income from investments that exceeds £5,000, that partner should consider transferring investments into the name of his/her spouse if he/she has a dividend allowance available – or pays tax at a lower rate. This could particularly be the case for a person who is drawing dividends as remuneration from a private company (and so using their £5,000 allowance) but also has dividends from investments.

For those who are concerned that dividend income takes them over their £5,000 dividend allowance, they should consider investing in equities via an ISA – especially those producing a high yield.

(b) Trustees

Trustees of a discretionary trust will not get a dividend allowance. For them, dividend income that falls within their standard rate band of £1,000 will be taxed at 7.5% with excess income taxable at 38.1%. For such trustees, there will therefore be even more of an incentive to invest for capital growth rather than income. Thought can then be given to realising investments to use the trustees' annual CGT exemption of, usually, £5,550 in future years or, perhaps, where there is a desire to distribute larger benefits, make a transfer of investments to a beneficiary and claim CGT hold-over relief.

Alternatively, trustees could use a single premium bond, which is a non-income producing investment and does not generate taxable income, and instead accumulate dividend income in the life office funds. Tax-efficient encashments within the 5% part surrender allowances can be made to generate cash for a beneficiary if required. If it is desired to release larger sums from the trust for the benefit of a beneficiary, the trustees could consider assigning policy segments to a beneficiary. On encashment, the beneficiary would normally pay a lower rate of tax on the encashment gain than the trustees.

(c) Directors/shareholders of private limited companies

The other category of individual who will suffer because of the new dividend rules is the shareholder/director of a private limited company who has been drawing remuneration in the past by way of dividends to avoid National Insurance contributions (NICs).

Boris, who is a director/shareholder of Footrests Ltd, has £25,000 of gross profits in his company which he wishes to draw, either as bonus or dividend. Assuming the company pays corporation tax at the rate of 20% and the director already has annual income in excess of £43,000, of which dividends already account for more than the dividend allowance, the choice can be summarised as follows:-

	Bonus £		Dividend £	
	Higher rate	**Additional rate**	**Higher rate**	**Additional rate**
Marginal gross profit	25,000	25,000	25,000	25,000
Corporation tax @ 20%	N/A	N/A	(5,000)	(5,000)
Dividend	N/A	N/A	20,000	20,000
Employer's National Insurance Contributions £21,968 @ 13.8%^	(3,032)	(3,032)	N/A	N/A
Gross bonus	21,968	21,968	N/A	N/A
Director's NICs £21,968@ 2%	(439)	(439)	N/A	N/A
Income tax *	(8,787)	(9,886)	(6,500)	(7,620)
Net benefit to director	**12,742**	**11,643**	**13,500**	**12,380**

^ *The Employment Allowance is assumed to already be used or not available.*

**Tax on dividends at 32.5% for higher rate taxpayer and 38.1% for additional rate taxpayer.*

Regular changes to NICs and tax rates have altered the mathematics in the choice between dividends and salary, with the introduction of the new dividend tax rules from 2016/17 being the most recent revision to have an impact.

There is little doubt that the new dividend rules will make such a strategy less attractive yet, even after the changes, it will still be more attractive than drawing only salary/bonus – at least up to total remuneration of about £150,000 (but precise calculations based on circumstances need to be made), with up to £8,060 paid as salary to secure entitlement to State benefits. For such people who want to improve the tax efficiency of the benefits they draw from the company, they should look more closely at planning strategies that involve contributions to registered pension schemes. Of course, an eye should be kept on not exceeding the annual allowance or the lifetime allowance.

For some business owners, the ultimate way to limit their tax bill is to choose to leave profits in the company rather than draw them either as dividend or salary. With the top rate of income tax currently at 45%, there is an obvious argument for allowing profits to stay within the company, where the maximum current tax rate is 20%.

This strategy has tax risks in terms of eligibility for CGT entrepreneurs' relief and inheritance tax business property relief. In particular, HMRC is looking carefully at ways that it can apply income tax rather than capital gains tax to cash that is drawn out of a close company. Money left in the company is also money exposed to creditors, so professional advice should be sought before turning a business into a money box.

Capital Gains Tax (CGT)

Capital gains are taxed as the top slice of income, but the rates are currently lower than those that apply to income not covered by allowances. From 6 April 2016 the CGT rates have been cut by 8% so gains will generally be taxable at 10% to the extent they fall in the basic rate band and 20% if they fall into the higher or additional rate bands. However, for gains on residential property (eg buy-to-lets) and carried interest, the 2015/16 tax rates of 28% and 18% will continue to apply. The capital gains tax annual exemption for 2016/17 remains unchanged at £11,100 because inflation (as measured by the Consumer Prices Index) to last September was below zero.

The tax rates and annual exemption (per person, not per couple) mean that if an investor can arrange for investment returns to be delivered in the form of capital gains rather than income, he/she will often pay little or no tax on profits. While investment decisions should never be made on tax considerations alone, traditionally favouring capital gains over income when setting investment goals has been a sensible approach. However, with the new dividend allowance, this will no longer automatically be the case, despite the CGT rate cuts. Each investor's tax position will need to be analysed even more closely to determine the most appropriate investment strategy.

For investors who have realised capital gains within the last year and would pay CGT at 28% there may be scope to defer the payment of CGT on the gain by using EIS deferral relief. On a subsequent disposal the deferred gain would then be realised with a lower rate of CGT.

Individual Savings Accounts (ISAs)

The annual ISA investment limit for 2016/17 is unchanged at £15,240, but in 2017/18 will jump to £20,000. The limit for the Junior ISA (JISA), which is attracting more university-fee-planning investors, stays at £4,080 for 2016/17. 6 April 2016 has also seen the launch of the Innovative ISA, which allows investment in peer-to-peer (P2P) lending. This potentially offers higher rates than the current yields on cash ISAs but without security of capital or any deposit protection scheme coverage. From the same date new flexibility has been introduced to cash ISAs, allowing investors to replace any amount of withdrawn money without it counting towards the ISA allowance, provided the replacement occurs in the same tax year. This feature has been added because the arrival of the personal savings allowance, offering up to £1,000 of tax-free interest, has reduced or eliminated the benefits of a cash ISA for many savers.

Nevertheless, ISAs remain one of the simplest ways to save tax, with nothing to report or claim on the investor's tax return. The annual limit may be modest, but over time substantial sums can build up: if an investor had maximised the ISA investment since they first became available in April 1999, they would by now have placed over £150,000 largely out of reach of UK taxes.

Remember, ISAs are now inheritable by a surviving spouse or a civil partner, a process which is due to be simplified later in 2016 to avoid any income or CGT during the estate administration period. Alternatively, a surviving spouse can effect a new cash/stocks and shares ISA (outside of their personal limit) with a contribution equal to the value of the deceased's ISA at the date of death.

Lifetime ISAs

One of the Budget's big surprises was the announcement of the Lifetime ISA (almost certain to be called a LISA), to be launched in April 2017. Details of this will be subject to consultation, but the main features already decided are:

- Only those under the age of 40 will be eligible to invest.
- The maximum annual contribution will be £4,000 to which the government will add a 25% bonus, eg a £100 contribution will become worth £125 in the plan.
- The government bonus will be paid on contributions up to age 50.
- Funds, including the government bonus, can be used to buy a first home (worth up to £450,000) at any time from 12 months after opening the account, and can be withdrawn tax-free with the government bonus from age 60 for any use (although the intention here is that the funds will be used to boost financial provision in retirement).
- Withdrawals can be made at any time for other purposes, but with the bonus element of the fund plus any interest or growth on it forfeited *and* a 5% charge applied.

The government will examine the possibility of allowing penalty-free repayable loans against the plan and allowing penalty-free access before age 60 for specific life events other than purchasing a first home. Monies built up in a Help to Buy ISA will be transferable into the new plan during 2017/18. Savers with both a Help to Buy ISA and a Lifetime ISA will only be able to use the government bonus from one of these schemes to buy their first home.

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

VCTs and EISs have been subject to a range of rule changes in recent years, with some of the most significant being introduced last year in response to revised EU state aid rules. As a result, the nature of some schemes has changed; for example, VCTs can no longer make fresh investment in management buy-outs (MBOs).

Interest in VCTs and EISs has grown as more aggressive forms of tax planning, such as film leasing schemes, have come under sustained HMRC attack and pension opportunities have been further constrained. To recap, the main tax advantage of a VCT/EIS is the 30% income tax relief on contributions (of up to £200,000 per tax year in the case of VCTs and £1 million per tax year in the case of the EIS). Other attractive reliefs apply such as the ability to take tax free dividends from VCTs and to obtain CGT deferral relief with the EIS.

Extension to Entrepreneurs' Relief

Entrepreneurs' relief enables the owner of a non-quoted trading business to realise capital gains of up to £10 million and to only pay CGT at 10%.

A new form of entrepreneurs' relief (ER), investors' relief (IR), will extend the benefits of ER to external investors in unlisted trading companies. IR will apply a 10% rate of CGT to gains accruing on the disposal of ordinary shares in an unlisted trading company held by individuals, provided such shares were newly issued to the claimant and acquired for new consideration after 16 March 2016, and have been held for a period of at least three years starting from 6 April 2016. A person's qualifying gains for IR will be subject to a lifetime cap of £10 million, which is in addition to the existing ER cap.

ESTATE PLANNING

Nil Rate Band

The inheritance tax (IHT) nil rate band reached its current level of £325,000 in April 2009. It has been frozen since then and the summer 2015 Budget extended the freeze until at least April 2021. If the nil rate band had increased in line with inflation, it would be about £385,000 in the current tax year.

A frozen nil rate band means that more estates are dragged into the IHT net and, for people who are already caught, adds to the amount of tax that will be levied. Since April 2009, average UK house prices are up by about 32%, according to Nationwide, and UK share prices have risen by about 70% (March 2009 marked their low point in the wake of the financial crisis).

Main residence nil rate band

The Chairman of the House of Commons Treasury Committee recently complained that the proposed rules that apply to the new residence nil rate band were so complex that "the main beneficiaries would be tax advisers and lawyers."

The basis of the relief is, in broad terms, that if a person leaves an interest in a private residence to direct descendants on their death, they will qualify for an extra nil rate band of £100,000 from 6 April 2017 rising to £175,000 in 2020/21. If the relief is not used on the first death of a spouse/civil partner, it is transferable to the survivor.

While no further changes were announced in the Budget, the Finance Bill 2016 does include some fairly complex downsizing provisions. These enable people who downsize (or gift) properties before their death to still qualify for an element of residence nil rate band provided that a part of the sales proceeds (or investments representing it) is left to direct descendants of the deceased on death.

IHT Yearly Exemptions

The extended nil rate band freeze makes it even more important for people who are in the 'IHT net' to use the yearly IHT exemptions such as:-

- *The £250 small gifts exemption.* A person can make as many outright gifts of up to £250 per individual per tax year as they wish free of IHT, provided that the recipient does not also receive any part of their £3,000 annual exemption.
- *The £3,000 annual exemption.* Any unused part of this exemption can be carried forward one tax year, but it must then be used *after* the £3,000 exemption for the current tax year. So, for example, if a person made a gift of £1,000 covered by the annual exemption in 2015/16, they can make gifts totalling £5,000 covered by the annual exemption in 2016/17 by 5 April 2017.
- *The normal expenditure exemption.* Any gift made is exempt from IHT if:
    - it forms part of the donor's normal expenditure; and
    - taking one year with another it is made out of income; and
    - it leaves the donor with sufficient income to maintain their usual standard of living.

The annual and normal expenditure out of income exemptions are very useful exemptions for covering the gifts that arise from an individual paying premiums on a life assurance policy that has been set up in trust to provide tax-efficient funds to meet IHT on that individual's death.

BUSINESS OWNERS

Corporation Tax Rate

The rate of corporation tax remains at 20% for the financial year starting on 1 April 2016 – there is now no small profits rate (formerly smaller companies' rate). A cut to 19% is due next year, with the further reduction scheduled for 2020, originally to 18%, now to be to 17% following an announcement in the Budget.

The falling rate of corporation tax is one of the reasons why the Chancellor announced a reform of dividend taxation last summer. Lower corporation tax rates strengthen the case for incorporation as an attractive tax option for business people. Operating via a company creates the opportunity to draw income as dividends, free of NICs, and shelter profits at corporation tax rates rather than personal income tax rates of up 45%. The higher rates of tax on dividends above the new £5,000 dividend allowance are designed to claw back some of the lost NICs revenue and discourage business owners from drawing dividends as opposed to salary/bonus.

Despite reducing corporation tax rates, contributions into registered pension schemes will remain probably the most tax-efficient way for a director to draw sums out of the company.

Dividends or Salary...

For shareholder/directors looking to draw up to about £150,000 (but precise calculations based on individual circumstances need to be made) out of the business and able to choose between the two routes, a dividend remains the more efficient choice even if no dividend allowance is left.

PENSIONS PLANNING

The pensions landscape has altered dramatically in recent years and will continue to change.

A month before the Budget the hot tip for change was pensions tax relief. As it transpired no changes were made apart from some technical amendments. However, it seems almost inevitable that changes will be made in the future.

The Budget did, however, introduce a few 'technical tidy-up' amendments. Of prime importance was the announcement that legislation will be introduced to ensure that the "omission to exercise a right" provisions will not apply where a pension scheme member dies with undrawn funds that had been designated to drawdown. This effectively means that on the death of a pension scheme member or beneficiary, no value will be included in that person's taxable estate in respect of the pension fund – whether the funds are crystallised or in drawdown.

Salary Sacrifice

National Insurance contributions (NICs) can cost up to 25.8% of gross pay – up to13.8% for the employer and 12% for the employee. The corollary is that avoiding NICs can save up to 25.8% of pay. A widely applied example of turning NICs to an advantage is in the use of salary sacrifice to pay pension contributions. Instead of the employee making personal contributions out of their net pay, the employee

accepts a lower salary and the employer makes a pension contribution on behalf of the employee. If the employer passes on all of the NICs savings, the pension contribution could be up to almost 34% higher, as the example below shows.

An attack on salary sacrifice in the Budget had been expected by some commentators, but instead the government said that its "intention is that pension and childcare savings should continue to benefit from income tax and NICs relief when provided through salary sacrifice arrangements."

The following table demonstrates how a salary sacrifice arrangement can improve the amounts contributed to a pension plan provided the employer is prepared to pass on any NIC saving.

A Worthwhile Sacrifice

	Personal Contribution		**Salary Sacrifice Employer Contribution (sacrificed amount plus NIC saving)**	
Tax Rate	**20%**	**40%**	**20%**	**40%**
	£	**£**	**£**	**£**
Gross Salary	1,000	1,000	Nil	Nil
Employer Pension Contribution	Nil	Nil	1,138	1,138
Employer NI Contribution (13.8%)	138	138	Nil	Nil
Total Employer Outlay	1,138	1,138	1,138	1,138
Employee Salary	1,000	1,000	Nil	Nil
Less Income Tax	(200)	(400)		
Less NI Contributions (12%/2%)	(120)	(20)		
Net Pay = Net Pension Contribution	680	580		
Tax Relief	170	387		
Total Pension Contribution	**850**	**967**	**1,138**	**1,138**

And don't forget that from 6 April 2016 a number of new pension tax relief rules apply that we already knew about. For example:-

- there are new rules which could effectively taper down the total amount of tax-efficient contributions that can be made to an individual's pension arrangements if their "threshold income" exceeds £110,000 and their "adjusted income" (which is not just earnings) exceeds £150,000.

- the lifetime allowance – in effect the maximum tax-efficient value of pension benefits – has been cut from £1.25m to £1m. New transitional protections are available and although final details will not appear until the summer, HMRC has introduced an interim claim procedure for those drawing benefits after 5 April 2016. Those opting for Fixed Protection 2016 should make sure that they pay no further contributions or benefit from no further pension accrual on or after 6 April 2016.

- The new single-tier state pension started on 6 April 2016. While it will not affect people who reach SPA before then, there is now the opportunity to top up pre-April 2016 state pension by making new Class 3A National Insurance contributions before 6 April 2017.

Given that pension tax change is very likely in the future, individuals (particularly higher rate taxpayers) should maximise pension provision while they can.

COMMENT

So, all in all, a lot is happening in the area of personal taxation that affects a vast area of financial planning – plenty to discuss.

For any information on what we suggest as regards the most appropriate financial products for your needs, please contact us.

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