UHY Financial Planning

review
SPRING 2017

The benefits of transfers?

The overwhelming majority of people who have been fortunate enough to be a member of a defined benefit (also known as 'final salary') occupational pension scheme should stay with it. After all, there is not much wrong with a guaranteed, inflation-linked income, which you cannot outlive.

However, wealthier clients may be more concerned about inheritance tax and the amount of income tax they pay rather than the prospect of running out of money. For such people the higher transfer values currently available will be good news. There are three factors that are driving up transfer values but the first – falling interest rates from UK government bonds (gilts) – is having the greatest impact.

Falling gilt yields – The economic uncertainty produced by the vote to leave the EU has seen investors moving into safe havens; gilts have been a major beneficiary of this trend. The increased demand has pushed prices high and as a result reduced gilt yields to historic lows. With the lower expected future returns from gilts, pension schemes have had to assume higher current values to provide the guaranteed future benefits – which in turn have resulted in higher pension transfer values. With Brexit expected to be no earlier than March 2019, these conditions are likely to continue for some time.

Lower expected investment returns – We currently live in an economy with low inflation and low interest rates. This doesn't just drive up pension transfer values. In addition, defined benefit (final salary based pension schemes) are paying out more of their funds in retirement benefits to pensioners. So they are expected to take less investment risk by reducing the proportion of their funds in equities and switching to gilts and fixed interest stocks.

Improved life expectancy – Life expectancy at older ages in England for example has risen to its highest ever level. This is a generally welcome development, but it can be a headache for pension schemes that must now expect to pay pensions for longer and this is again reflected in higher transfer values.

It does not follow that higher transfer values mean that more people should transfer. After all, what most people want is a guaranteed and increasing income for life when they are faced with living longer and getting lower investment returns. But for those with enough wealth to be really confident about their own future financial security, the present transfer values could be worth considering.

Occupational pension schemes are regulated by The Pensions Regulator. Tax laws can change. The Financial Conduct Authority does not regulate tax advice.

In this issue:

UHY Financial Planning Ltd
14 Park Row
Nottingham NG1 6GR
Telephone: 0115 959 0900

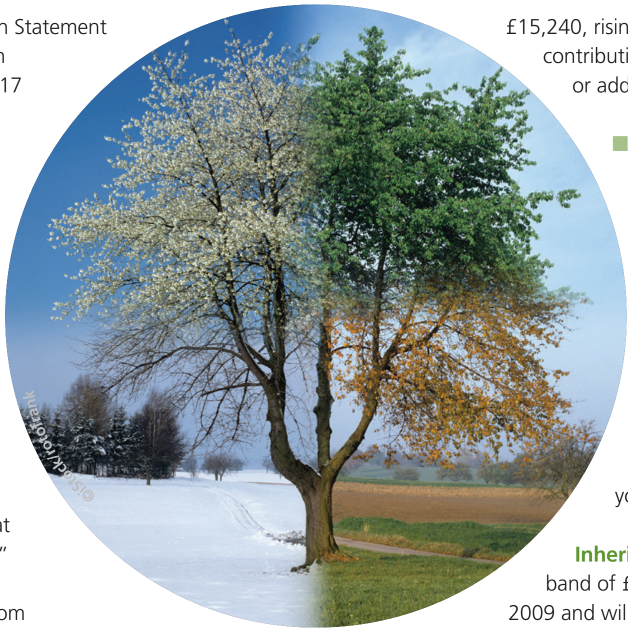
Adviser – Adam Wing BA (Hons) DipPFS
Financial Planning Manager

Quadrant House
4 Thomas More Square
London E1W 1YW
Telephone: 020 7216 4600

Adviser – Peter Miller APFS
Chartered Financial Planner

Focus on your year end checklist

Philip Hammond's first – and last – spring Budget on Wednesday 8 March could make early tax year end planning all the more important in 2017.



The big surprise in Mr Hammond's Autumn Statement was that he would be reverting to Autumn Budgets, last seen in the 1990s. So the 2017 Spring Budget will be the last of its type and it will be the first of two Budgets this year. Your 2016/17 tax year end checklist starts with pensions, but there are several other areas which also need examination.

Pensions – In a paper published alongside the 2016 Autumn Statement, the Treasury noted that in 2014/15 tax relief on pensions "cost around £48 billion, with around two thirds of the tax relief going to higher and additional rate taxpayers." The Treasury paper then remarked"…it is important that resources focus where there is most need."

Mr Hammond's predecessor shied away from ending higher (and additional) rate tax relief on pension contributions in 2016. Given the state of government finances, Mr Hammond may be less timid.

Individual Savings Accounts (ISAs) – The current ISA contribution limit is £15,240, rising to £20,000 in 2017/18. Maximising ISA contributions remains important if you are a higher or additional rate taxpayer:

- All income within ISAs is free of personal UK tax.
- An ISA and all its tax benefits can effectively be inherited by a surviving spouse or civil partner.
- Gains made within ISAs are free of capital gains tax (CGT).

CGT annual exemption – As a broad rule, you should consider whether it is worth realising some of your gains to use your £11,100 annual CGT exemption.

Inheritance tax (IHT) – The main IHT nil rate band of £325,000 has been frozen since 6 April 2009 and will remain so until April 2021, making it all the more important that you use your annual IHT exemptions, including the £3,000 annual exemption.

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Estate planning with your pension

It may sound strange, but your pension could be the last thing you should draw on in retirement.

Over the last five tax years the amount paid in inheritance tax (IHT), nearly all of which is collected on death, has risen by over 70%. However, there is one area where the IHT rules have become noticeably more favourable pensions.

A range of reforms has made defined contribution (money purchase) pensions, such as personal pensions, a valuable tool in estate planning. The broad rules are now:

- Pension death benefits are generally free of IHT.
- If death occurs before age 75, any benefits – lump sum or as income – are also free of income tax.
- On death on or after age 75, benefits are subject to income tax, based on the beneficiary's tax position.

The freedom from IHT and, before age 75, income tax means that from an estate planning viewpoint leaving your pension untouched until at least your 75th birthday will often be the sensible course of action.

If you are thinking "Good idea, but what do I live on?", then the answer depends upon a variety of factors. Drawing on existing non-pension investments could be a solution, as the example shows.

Pension vs investments: the IHT case

Gordon has an estate worth £800,000, with £350,000 in a portfolio of funds, and another 350,000 in a self-invested personal pension. He needs £20,000 a year to top up his existing pension income, which after tax means taking about £23,500 a year from his pension plan.

If Gordon dies before age 75 having received £20,000 a year net for 10 years (and ignoring any investments returns or changes in the nil rate band) his beneficiaries would have £840,000 instead of just £725,000 – and increase of £115,000 or over 15%.

Income Source	Portfolio £	Pensions £
Value of estate	600,000	800,000
IHT on estate	(110,000)	(190,000)
Net estate	490,000	610,000
Pension fund – IHT-free	350,000	115,000
Total to beneficiaries	**840,000**	**725,000**

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More than 700,000 small employers (generally those with under 30 employees) will see their workplace pensions duties start in 2017, according to the Pensions Regulator. The latest data about compliance with the automatic enrolment rules show that the regulator has been busy chasing those employers who have missed their deadlines.

In the three months between August and September 2016, over 15,000 compliance notices were issued, as well as more than 3,700 fixed penalty notices of £400. There were some 576 penalty notices involving fines of up to £10,000 per day in the quarter, more than three times the total figure for the nine months up to June 2016.

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Buy-to-let: a taxing issue

April will mark the start of another measure designed to increase tax for buy-to-let investors.

Buy-to-let (BTL) investors are about to experience the start of a third adverse tax change in April. Last year saw an increase in stamp duty across all of the UK and the end of 10% wear and tear allowance, both of which have already started to alter the economics of BTL investment.

From 6 April 2017, only three quarters of interest on any BTL mortgage can be set against rent for tax purposes, with a 20% tax credit given for the remaining quarter. By 2020/21 there will be no offset and in its place will be a 20% tax credit for all interest paid, equivalent to basic rate relief.

If you are a higher or additional rate taxpayer, this will mean a drop in net income. A typical example based on rental income of £10,000 and interest of £6,000 paid by a higher rate taxpayer is shown below.

	2016/17 £	2020/21 £
Rental income	10,000	10,000
Interest paid and offsetable	(6,000)	–
Taxable income	4,000	10,000
Tax @ 40%	(1,600)	(4,000)
Interest paid not offsetable	–	(6,000)
Interest tax credit @ 20%	–	1,200
Net income	**2,400**	**1,200**

The fact that by 2020/21 your full rental income (less expenses) will be taxable means an increase in your total taxable income. This could mean you cross an income threshold, triggering extra tax, or you are pushed into a different tax band.

And before you think "I'll sell up", remember that there was no cut in the capital gains tax (CGT) rates for residential property: they stay at 18% within the basic rate band and 28% above. Worse still, from April 2019, CGT on residential property will be payable within 30 days of sale.

All these tax changes have significantly reduced the appeal of BTL for many, even before you consider the possibility that interest rates could start rising in the future.

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Your home may be repossessed if you do not keep up repayments on a mortgage or other loans secured on it. Think carefully before securing other debts against your home. Business buy to let and commercial mortgages are not regulated by the FCA. Think carefully before securing other debts against your home.

Curtains for the Autumn Statement

The Autumn Statement in November last year was the new Chancellor's first set piece, but it did not contain much good news.

Mr Hammond's first-and-last Autumn Statement contained a range of measures which marginally raised tax income, including:

Salary sacrifice schemes The income tax and national insurance advantages of salary sacrifice schemes, such as exchanging salary for a tax-free mobile phone, will largely disappear from April. This will reduce the benefits of pick-and-mix remuneration packages, although there will be transitional protections for existing arrangements and salary sacrifice to boost pension contributions will not be affected.

Money purchase annual allowance This reduced pensions annual allowance was introduced last April to limit the scope for recycling flexible pension income as fresh, tax relieved pension contributions. It was initially set at £10,000, but from 2017/18 it will be just £4,000. If you are planning to phase your retirement, this reduction could complicate matters.

Tax evasion and avoidance The usual raft of measures were aimed at increasing revenue, some of which had already been trailed by Mr Hammond's predecessor, George Osborne. One important new rule will be a legal "requirement to correct" by 30 September 2018 any "offshore tax non-compliance" existing on 6 April 2017.

If any of these measures could affect you, please contact us for further information and advice.

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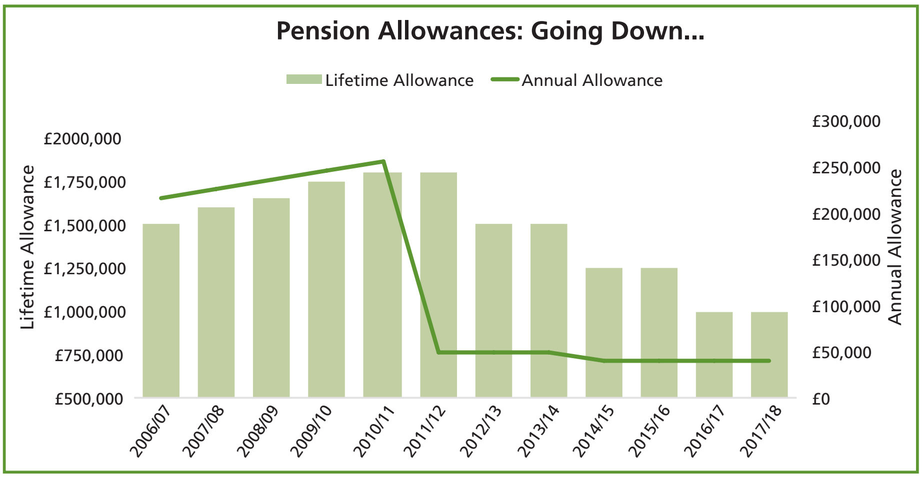
Your shrinking pension allowances

The cuts and adjustments made to the two main pension allowances since 2011 have made retirement planning all the more complex.



The lifetime allowance, which sets an effective tax-efficient ceiling on the total value of pension benefits, was £1,800,000 in 2010/11. Back then, the corresponding annual allowance, which sets an effective tax-efficient ceiling on annual pension contributions, was £255,000. Dividing the lifetime allowance by the annual allowance suggests it would have taken about seven years of contributions at the rate of the annual allowance to reach the lifetime allowance. In theory at least, you could have deferred pension planning until less than ten years before your retirement date.

For 2016/17 the lifetime allowance is £1,000,000, while the annual allowance has a £40,000 maximum for most people. So now it would take 25 years to reach the maximum, based on dividing the current lifetime allowance of £1,000,000 by the annual allowance of £40,000 – and ignoring any investment growth.

These two calculations underline how important it has become to start pension planning as soon as practical and keep making contributions each year. There is scope to carry forward unused annual allowances, but only for the previous three tax years. For example, you have until 5 April 2017 to mop up any of your unused £50,000 annual allowance for 2013/14. However, you must first have exhausted the current tax year's allowance.

To complicate matters further, the private sector final salary schemes and HM Revenue & Customs use different valuation bases, so a transfer could push you over the lifetime allowance, even with no fresh contributions. The constraints now applying to both the lifetime and annual allowance make regular reviews of your retirement strategy all the more important, particularly if you are considering large contributions as the tax year end approaches.

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The Financial Services Compensation Scheme protection limit for deposits with banks and building societies returned to £85,000 on 30 January 2017. The £10,000 increase, which has been subject to regulatory consultation, is the result of the recent decline in the value of the pound against the euro. Under EU law, deposit protection is set at €100,000 or its currency equivalent. If you are holding such high levels of cash, you should first review how much money you need on deposit. At best, instant access accounts offer a sub-inflation 1%, but many pay considerably less.

ISAs and estate planning

ISAs have traditionally been seen as a foundation for good financial planning because of their general tax efficiency. However, they have had a negative effect on estate planning because they form part of the deceased's estate for inheritance tax (IHT) purposes.

Two recent changes could make ISAs more useful for estate planning.

A spouse or civil partner can now effectively inherit a deceased person's ISA savings. This is helpful for general tax planning but on its own it will not save IHT, because this tax would normally only be charged when the survivor eventually dies.

More important, ISAs can benefit from business property relief (BPR) to the extent that they are invested in qualifying AIM (Alternative Investment Market) stocks. Once you have owned BPR-qualifying shares for at least two years, you can pass them on death free from IHT. AIM stocks are generally much higher risk that a typical stocks and shares ISA portfolio. But the higher risk needs to be considered against a potential loss of 40% IHT (for those with larger estates).

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