

Capital Gains Tax

Following the introduction of a flat-rate tax of 18% on Capital Gains introduced on 6 April 2008, one of the much anticipated tax changes in the run up to this year's June Budget was a rise in Capital Gains Tax (CGT), with many fearing that the CGT rate could even be hiked up to 40 or 50% to prevent high earners exploiting the 18% CGT rate in preference to paying increased rates of income tax.



Example: John is a basic rate taxpayer as he has taxable income (after personal allowances) of £30,000. On 30 June 2010, however, he sells shares he owns triggering a capital gain of £50,000.

The first £10,100 of this gain is free of tax as it is covered by the annual exempt amount mentioned earlier.

Of the remaining £39,900, the next £7,400 of this gain (taking him up to the basic rate tax threshold of £37,400) would be taxed at 18% but the remaining £32,500 (£39,900 - £7,400) would be subject to the higher rate of 28%! This results in a total 'effective' tax rate of 21% whereas prior to the Budget announcements John would have just paid a flat-rate of 18% on the whole gain.

Although a rise in the Capital Gains Tax Rate was perhaps inevitable, fortunately the news was not as bad as originally predicted with the Chancellor announcing a rise in the CGT rate for disposals made on or after 23 June 2010 to 28% for higher rate taxpayers with the 18% CGT rate remaining for basic rate taxpayers. The annual exempt amount of £10,100 for tax year 2010/11 remains so only gains in excess of this amount will be subject to tax.

So who exactly will be affected by this tax increase?

Contrary to the Chancellor's inference that the 28% rate affects only higher

rate taxpayers, individuals who are currently basic rate taxpayers could also be affected if they make significant capital gains – This is because any gains made on or after 23 June 2010 are now added to your taxable income for that tax year and any portion of the gain in excess of the basic rate income tax threshold (currently £37,400 for 2010/11) would be subject to tax at the higher rate of 28%.

Individuals who have income well below the basic rate income tax threshold could therefore easily be affected. For example, the sale of a buy-to-let property (or any other valuable asset/investment for that matter) could result in a capital gain that, when added to

your income, pushes you into the higher rate tax band.

It is also important to remember that, where you have disposed of assets both before and after 23 June 2010 you will need to report these separately to ensure you don't pay too much tax – Remember that any disposals made in the 2010/11 tax year but before this date will still only be liable for CGT at 18%!

It is also important to be aware that assets can be transferred between spouses without triggering a CGT liability – This is a useful way of making use of two annual exempt amounts by first transferring assets to your spouse before each disposing of your share, enabling capital gains of up

to £20,200 (2 x £10,100) before any tax is due. In some circumstances this can also be a way of avoiding the 28% tax rate altogether.

We can, however, only give a brief overview of these changes in this article. Capital Gains Tax can be a complex area and it is therefore essential that you seek guidance from your Financial Adviser before taking any action, particularly if you are thinking of encashing investments or disposing of assets that could result in a capital gain.

Levels and bases of, and reliefs from, taxation are subject to change and taxation rates depend on the circumstances of the individual investor.

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All Change

With two budgets being held this year, it can be difficult to keep track of all the changes that are either proposed or being implemented and the date they take effect. In order to allow you to maximise your planning potential we thought it would be useful to summarise the changes that are due to come into effect from 2011 and beyond.



VAT

VAT is currently 17.5%, but is being increased to 20% from 4th January 2011. There will be no change to items that are currently VAT exempt and the 5% reduced rate (which applies to some items such as child car seats and domestic power) stays the same.

If you are looking to purchase an expensive item, on which VAT will be charged you may wish to consider doing so before the end of the year to avoid the increase.

Insurance Premium Tax

Insurance Premium Tax is a tax on general insurance premiums. Contracts to which this will apply include car, home, private medical and travel insurance. There is currently a standard rate of 5% and a higher rate of 17.5% for travel insurance and some insurance for vehicles and domestic/electrical appliances. The new levels of Insurance Premium Tax that will apply from 4th January 2011 are 6% for the standard rate and 20% for the higher rate.

Income Tax Personal Allowance

From 6th April 2011, the income tax personal allowance for people under

65 will be increased by £1,000 taking it from £6,475 in 2010-11 to £7,475 in 2011-12. This is good news for those on lower incomes as they will potentially save £200 in income tax for the year, or be removed from paying income tax altogether.

Higher rate taxpayers will not benefit however, as the maximum income level to which basic rate income tax applies (currently £37,400) will be reduced to ensure that they will pay the same total level of income tax. The exact figures are not currently known, as these will be confirmed at some point in the autumn.

National Insurance Contributions

The government has announced that the employee, employer and self-employed rates of National Insurance contributions (NICs) will increase by 0.5% from April 2011 in addition to the 0.5% increase announced in 2008. The starting point at which employers pay National Insurance will increase by £21 per week above indexation.

Corporation Tax

The main rate of corporation tax will be reduced from 28% to 27% from 1st April 2011, with further reductions to 26% in 2012-13, 25% in tax years 2013-14 and 24% in tax year 2014-15.

The Budget also announced a reduction in the small profits rate of corporation tax from 21% to 20% from 1st April 2011.

State Pension

The Government will uprate the basic State Pension by a triple guarantee of the highest of earnings, prices or 2.5% from 6th April 2011. The Consumer Price Index (CPI) will be used as the measure of prices, although the basic State Pension will increase by at least the equivalent of the Retail Prices Index (RPI) in April 2011 to ensure its value is at least as generous as under previous uprating rules.

The standard minimum income guarantee in Pension Credit will increase in April 2011 by the cash rise in the full basic State Pension.

Tax Credits and Child Benefit

The child element of the Child Tax Credit will increase by £150 above CPI in April 2011. The baby element of the Child Tax Credit will be removed from 6th April 2011.

From 2011-12, both rates of Child Benefit will be frozen for three years. The weekly payments for the eldest/only child of £20 and £13.40 for other children will therefore not be increasing in the near future.

The Government will reduce the tax credit eligibility for families with household income above £40,000 from 6th April 2011. Further changes will be introduced in 2012-13 although these are not yet known.

Health in Pregnancy Grant

The Health in Pregnancy Grant is a £190 one-off payment to all expectant mothers irrespective of income. The Government considers the universal Grant to be a poor use of limited public funds and has announced that it is to be abolished from 1st January 2011 to help reduce the deficit in a fair way. Women who reach the 25th week of pregnancy before 1st January 2011 will still be entitled to the grant providing they satisfy the relevant conditions.

Child Trust Fund - Restriction of government contributions

The Government has announced that it intends to reduce and then stop all government contributions to Child Trust Funds. Subject to legislation, the Government intends to reduce government contributions at birth, and to stop government contributions at age seven from August 2010. The Government also intends to stop issuing new Child Trust Fund vouchers from 1st January 2011.

Summary

As the above demonstrates, there are a number of changes due to be implemented. Some such as the VAT and Insurance Premium Tax rise will potentially increase costs for everyone, others, for example, the increase in the income tax personal allowance for those under 65 and the increase in the National Insurance thresholds will potentially benefit those on low incomes.

Some of the changes, for example the removal of the health in pregnancy grant and the restriction of the Government's contributions to Child Trust Funds, are practical examples of the Government reigning in their spending to reduce the huge deficit that is currently faced.

Compounding the situation

A question that is often asked is 'when is it best to invest?' Many people will have their own answers such as:

'When the market is low'

'When there is stability in the markets'

'Only on a drip feed basis to reduce risk'

'Only when you can afford to'

'When the market is rising'

'When the market is falling'

There is nothing to say that any of these are wrong but how right they are depends upon the individual's personal circumstances such as their appetite for risk, affordability, financial requirements & term of investment.

So where does this leave us in relation to the question? Well, the one aspect that applies to all circumstances is to invest as early as you can afford - the main reasoning behind this is the effect of compound growth/interest. Time can be an important factor in the eventual returns you can get, dependent upon when you invest.

There are 2 main types of growth/interest described as follows

Simple - this is interest or growth

based on the original sum invested only each and every period.

Compound - this is interest or growth based on the original sum and previously attributed interest/growth.

Therefore, compounding growth/interest will provide a greater return than the simple variant as you will get growth on previous growth/interest as well.

It does need to be remembered, however, that growth or interest rates are not always guaranteed to remain level, or to beat inflation (if it does not then the purchasing value of your money will fall) and in respect of growth, this can actually be negative.

Imagine the following situation – you have twins both looking to have a lump sum when they reach the age of sixty. The first twin (A) starts work not long after leaving high school and invests £1,000 per year for ten years until he finds other needs for his spare income. The second twin (B) goes to university and cannot afford to start saving until ten years after her brother started, but continues until age 60.

They both invest in exactly the same investment vehicle and receive annual growth of 7% per year. The surprising results can be seen in the table below:

Age invested	Twin A		Twin B	
	Amount invested	Accumulated amount*	Amount invested	Accumulated amount*
16	£ 1,000.00	£ 1,070.00		
17	£ 1,000.00	£ 2,214.90		
18	£ 1,000.00	£ 3,439.94		
19	£ 1,000.00	£ 4,750.74		
20	£ 1,000.00	£ 6,153.29		
21	£ 1,000.00	£ 7,654.02		
22	£ 1,000.00	£ 9,259.80		
23	£ 1,000.00	£ 10,977.99		
24	£ 1,000.00	£ 12,816.45		
25	£ 1,000.00	£ 14,783.60		
26		£ 15,818.45	£ 1,000.00	£ 1,070.00
27		£ 16,925.74	£ 1,000.00	£ 2,214.90
58		£ 137,862.09	£ 1,000.00	£ 127,258.76
59		£ 147,512.43	£ 1,000.00	£ 137,236.88
totals	£ 10,000.00	£ 157,838.30	£ 34,000.00	£ 146,843.46

* includes compounding growth. Example is for illustrative purposes only and does not represent the past performance of a particular investment



By investing 10 years earlier Twin A has a larger lump sum at age 60 even though he has only invested £10,000 compared to Twin B's £34,000.

To further emphasise the benefit of compounding growth – if instead Twin A had received only simple growth of 7% then at age 60 the final figure would have been a mere £38,350.

Investing early can reap greater rewards at a lower cost (although inflation will erode the value).

But remember that the situation also works in reverse – if you are paying compound interest on an amount borrowed (such as with a mortgage) the longer the loan the greater the cost.

The value of investments may fall as well as rise and you may not get back the full amount invested.

Pensions and the Budget 2010

Restrictions on tax relief

The annual allowance is an annual limit on the amount of 'pension benefit' that can be built up in a tax advantaged environment. The annual allowance is currently set at £255,000 and if the total of employer and employee contributions to money purchase schemes (together with the increase in the capital value of any benefits held under a final salary scheme) exceeds this annual limit, the individual is subject to a flat rate tax charge on the excess (40% in 2010/11).

In his emergency budget statement on 22 June 2010, however, the Chancellor announced that the main feature of the post April 2011 pension funding regime will be a significantly reduced annual allowance of between £30,000 and £45,000 a year.

For the remainder of the 2010/11 tax-year, therefore, (and as long as you are not a 'high earner' caught by the 'special' annual allowance restrictions) if you have Relevant UK earnings of more than the proposed reduced annual allowance it would probably be a good idea to maximise making tax-relievable personal contributions whilst you still can.

'Relevant UK earnings' includes earnings from employment and self-employment – but not unearned income from savings and investments or pension income.

To illustrate the potential advantage of maximising personal contributions now, someone with Relevant UK earnings of £80,000 in 2010/11 could obtain tax-relief on a gross personal contribution of £80,000, but if in 2011/12 the annual allowance is reduced to, say, £40,000, the maximum tax relievable contribution would be halved.

With the impending increase to national insurance contributions due to come into force from 6 April 2011 as-well, the appeal of salary and bonus sacrifice arrangements will also increase.

Abolition of the requirement to purchase an annuity and the introduction of capped and flexible drawdown.

The current requirement for people with money purchase schemes, who do not want to utilise income drawdown, to purchase an annuity no later than age 75 will be abolished from 6 April 2011.

An annuity is still the most common retirement option in the UK and even though it won't provide flexibility of income it will provide a guaranteed income for life in exchange for a lump sum.

Income drawdown, on the other hand, enables you to take a flexible income within certain limits direct from your

pension fund, which remains invested, without having to buy an annuity. The key risk of income drawdown, however, is that your fund could be significantly (if not completely) eroded if the underlying investment returns are poor potentially leaving you with little or no income for the remainder of your retirement – There is no guarantee an income will be paid for life.

So what are the proposed changes?

From 6 April 2011, there will be no maximum age by which an annuity must ever be purchased, but to help those approaching their 75th birthday, the age at which an annuity must be bought has been temporarily increased from 75 to 77 with effect from 22 June 2010.

In practice, the announcement on 22 June to increase the upper age limit to 77 is really just a device to buy the Government time to introduce the relevant legislation and, in effect, simply acts an interim measure to ensure that any individual's who will attain age 75 on or after 22 June 2010 (but before 6 April 2011) will be able to benefit from the formal abolition next year.

The more restrictive income limits and death benefit rules that currently apply to people utilising income drawdown beyond age 75 will also be abolished and two new types of drawdown (capped and flexible) will be available both before and after age 75.

Capped drawdown

Under the capped option, it has been proposed that the ability to draw an income of between 0% and 120% of the otherwise available single life annuity (based on rates issued by the Government Actuaries Department) that is currently only available to those under age 75, will also be made available to individual's utilising drawdown beyond age 75, with no upper age limit. It has been stated, however, that the current upper income limit of 120% will be reviewed to see if this remains appropriate.

Flexible drawdown

Under the flexible option, individuals



will be able to withdraw unlimited amounts of income from their drawdown arrangement, both before and after age 75, provided that they have secured a minimum income to prevent them from exhausting their savings and falling back on the state.

The method of assessing this "Minimum Income Requirement" has yet to be decided although it has been proposed that this should be based solely on the individual's other pension income already in payment (including any state pensions) and the requirement to demonstrate a minimum income will apply at the point that an individual first wants to exceed the annual capped drawdown limit.

With regard to attaining age 75, the Government has also confirmed that, from April 2011, whilst benefits will continue to be tested against the lifetime allowance at age 75 and tax relief on member contributions will only continue to be available where these are paid prior to attaining age 75, it intends to remove the age 75 limit on tax-free cash payments and the ability to commute small pension funds as a lump sum under the 'trivial commutation' rules.

What action, if any, do I need to take?

If you are under age 75 and will not attain age 75 prior to 6 April 2011, you do not need to take any action.

Similarly, if you over 75 and already in drawdown, you do not need to do anything either as the new 'capped' and 'flexible' drawdown options should apply to your current arrangement from 6 April 2011.

If, however, you are currently under age 75 but will attain age 75 prior to 6 April 2011 and either (a) you are already in drawdown or (b) you would like to enter income drawdown with funds that have not yet been vested, it is important to remember that, for the remainder of the 2010/11 tax year, drawdown providers do not have to allow the more flexible income limits and death benefit options that are currently available prior to age 75, to extend beyond age 75.

So, if you are approaching age 75, and your provider will not offer this flexibility between you attaining age 75 and 6 April 2011, you may therefore want to consider the viability of transferring to another provider prior to your 75th birthday.

Furthermore, if you have pension rights that have not yet been vested, it is important to remember that you will need to vest those benefits prior to attaining age 75 in order to be able to draw 25% as a tax-free lump sum. If you reach 75 before 6 April 2011 and you do not take your benefits by your 75th birthday, any entitlement to a tax free lump sum will be lost.

For further advice on the technicalities of the changes and whether or not you should take any action, please speak to your financial adviser.

Please note that the proposed changes described above may still be subject to change and are currently subject to a period of consultation. This article is therefore based on our current understanding of the proposals.