Safehands Independent Financial Advisers Ltd.

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financial FOCUS

Your year end checklist: time to focus

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The benefits of transfers?

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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 generally a 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.

Estate planning with your pension

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

Inheritance tax (IHT) is one of those taxes that has been quietly ratcheting up its share of total government revenue. Over the last five tax years the amount paid in IHT, nearly all of which is collected on death, has risen by more than 70%. There are several reasons why IHT has been rising up the Exchequer's league table:

- The IHT nil rate band has not moved from £325,000 since 2009. If it had been linked to RPI inflation it would now be around £390,000.
- The annual exemption of £3,000 and small gifts exemption of £250 have been frozen for many years.
- A steady flow of new rules have reduced the scope for avoiding IHT. These have had a cumulative effect, increasing the amounts subject to tax.

But there is one area where the IHT rules have recently become noticeably more favourable: pensions. A range of reforms introduced by the previous Chancellor George Osborne have made defined contribution (money purchase) pensions, such as personal pensions, a valuable tool in estate planning. The broad rules are now:

- Lump sum and pension death benefits are generally free of IHT, whether death occurs before or after any pension benefits are drawn.
- 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.
- It is possible to pass a drawdown fund down through generations, enabling you to provide an income for your children and then your grandchildren.

Hang on to 75

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, including your other investments. For instance, if you have a portfolio of collective funds such as unit trusts, you could steadily liquidate that to provide the spending monies you need.

The process is very similar to income drawdown, but instead of taking taxable income from an IHT-free pension fund, you would be drawing mostly (or entirely) tax-free capital from investments that potentially suffer IHT. Over time, the difference in what your beneficiaries receive could be significant, as the example below shows.

The value of your investment can go down as well as up and you may not get back the full amount you invested. Past performance is not a reliable indicator of future performance. Investing in shares should be regarded as a long term investment and should fit with your overall attitude to risk and financial circumstances. The value of tax reliefs depends on your individual circumstances. Tax laws can change. The Financial Conduct Authority does not regulate tax advice.

Pensions v 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 after receiving £20,000 a year net for 10 years (and ignoring any investment returns or changes in the nil rate band) his beneficiaries would have £840,000 instead of just £725,000 – an increase of £115,000 or over 15%.

Income Source	**Portfolio £**	**Pension £**
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**

Your year end checklist: time to focus

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 one major surprise in Mr Hammond's Autumn Statement last November was that he would be reverting to autumn Budgets, last seen under Ken Clarke 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. It will be Mr Hammond's first Budget set piece and, in the light of the government's finances, it looks unlikely to offer many giveaways. As ever, your year end tax planning is best completed before the Chancellor reaches the despatch box.

The 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 "The cost of tax and National Insurance contributions relief on pension savings is one of the most expensive sets of relief offered by the government. In 2014 to 2015 this 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 came close to ending higher (and additional) rate tax relief on pension contributions in 2016. Given that £48 billion cost and the Treasury's need for additional tax income, Mr Hammond may be tempted to venture where Mr Osborne held back.

Individual Savings Accounts (ISAs)

The current ISA contribution limit is £15,240, which will rise to £20,000 in 2017/18. Maximising your ISA contributions remains important if you are a higher or additional rate taxpayer or pay capital gains tax (CGT), even though this tax year's savings and dividend tax changes may have cut some of your investment tax bill:

- All income within ISAs is free of personal UK tax and does not count towards to the dividend allowance or personal savings allowances.
- 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 CGT.
- There is nothing to enter on your tax return.

> The 2016/17 tax year end check list starts with pensions, but there are several other areas which also need examination.

CGT annual exemption

UK investors saw some useful gains in many of the major stock markets in 2016, partly because of sterling's post-referendum fall. If you have profits from your investments, as a broad rule you should consider whether it's worth realising some of your gains to use your annual CGT exemption. In 2016/17 you can realise gains of up to £11,100 without any liability to tax – a potential tax saving of up to £2,220 (£3,108 for residential property which doesn't benefit from another tax relief such as principle private residence relief). Crystallising gains could provide you with cash to make a pension or ISA contribution.

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. These include the £3,000 annual exemption, both for 2016/17 and any unused amount from 2015/16, and also the often forgotten normal expenditure out of income exemption. The tax year end is also a sensible time to review the impact on your estate planning of the main residence nil rate band, which starts life at a maximum of £100,000 in 2017/18. Get in touch with us if you have any questions on this new relief.

The value of tax reliefs depends on your individual circumstances. Tax laws can change. The Financial Conduct Authority does not regulate tax advice.

Deposit protection level increases back to £85,000

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.

Buy-to-let: a taxing issue

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

The BTL sector is 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
Taxable @ 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 the capital gains tax (CGT) rates were not cut for residential property: they remain 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.

Automatic enrolment fines escalate – don't join the list

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. If you're starting auto-enrolment this year, make sure you don't join the list. Occupational pensions are regulated by The Pensions Regulator

Curtains for the Autumn Statement

The 2016 Autumn Statement in November last year was the new Chancellor's first set piece, but it did not contain much good news.

£122,000,000,000 (£122 billion)

That is the increase in the government's projected total borrowing to 2020/21 between George Osborne's last spring Budget and Philip Hammond's first Autumn Statement. Faced with such a deterioration in government finances, the "fiscal reset" which Mr Hammond talked of when becoming Chancellor evaporated. Instead, there was a range of measures which marginally raised projected tax income, accompanied by a much larger increase in spending. The tax changes included:

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 arrangements in place before 2017/18. Most importantly, the use of 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.

Foreign pensions Several largely technical revisions affected foreign pensions. One side effect has been to reduce the attractions of transferring UK pension arrangements overseas.

VAT flat rate scheme A change to the VAT flat rate scheme will mean that many one person businesses, such a consultants, will see their VAT bills increase, with a corresponding drop in earnings.

Tax evasion and avoidance The usual raft of measures were aimed at increasing tax 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. The 2018 deadline reflects the full implementation of a new automatic information exchange between tax authorities around the globe. If any of these measures could affect you, please contact us for further information and advice.

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Individual savings accounts (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 the deceased'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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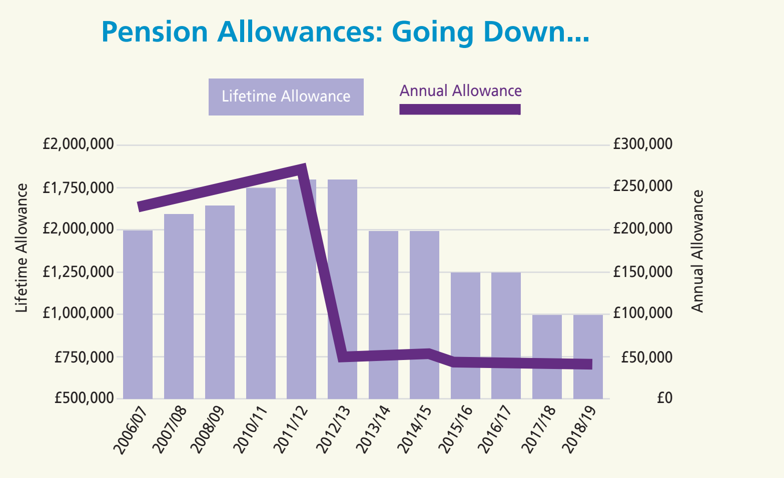
Your shrinking pension allowances

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 a decade before retirement.

For 2016/17 the lifetime allowance is £1,000,000 while the annual allowance has shrunk to 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 million by the annual allowance of £40,000 – and ignoring any investment growth. The lifetime allowance will start increasing from 2018/19, but only in line with the CPI inflation index. There is no corresponding adjustment planned for the annual allowance.

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 from 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 can only take advantage of the carry forward provisions once you 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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