Bulletin

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Armstrong Davis

Leading the Management of Wealth

Welcome to the economics of the madhouse!

Joe owns a bar in Kuala Lumpur. In order to increase sales, he decides to allow his loyal customers – most of whom are unemployed alcoholics – to drink now and pay later.

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He notes the drinks consumed on a ledger (thereby granting the customers loans). Word gets around and as a result increasing numbers of customers flood into Joe's bar. Taking advantage of his customers' freedom from immediate payment constraints, Joe increases his prices for wine and beer, the most-consumed beverages.

His sales volume increases massively. A dynamic account manager at the bank recognizes these customer debts as valuable future assets and increases Joe's borrowing limit. Joe sees no reason for undue concern since he has the debts of the alcoholics as collateral. At the bank's corporate headquarters, expert bankers transform these customer assets into DRINKBONDS, ALCBONDS and VOMIBONDS. These securities are then traded on markets worldwide. No one really understands what these abbreviations mean and how the securities are guaranteed. Nevertheless, as their prices continuously climb, the securities become top-selling items.

One day, although the prices are still climbing, a risk manager of the bank, (subsequently of course fired due to his negativity), decides that slowly the time has come to demand payment of the debts incurred by the drinkers at Joe's bar. However they cannot pay back the debts. Joe cannot fulfil his loan obligations and claims bankruptcy. DRINKBONDS and ALCBONDS drop in price by 95 %. VOMIBONDS performs better, stabilizing in price after dropping by 80 %. The suppliers of Joe's bar, having granted him generous payment due dates and having invested in the securities are faced with a new situation. His wine supplier claims bankruptcy; his beer supplier is taken over by a competitor. The bank is saved by the Government following dramatic round-the-clock consultations by leaders from the governing political parties.

The funds required for this purpose are obtained by a tax levied on the non-drinkers.... We hope you understand the above is a metaphor for property and mortgages and the economic situation in which the UK put itself.

Some interesting statistics to consider:

1. There are now as many homes for sale in Spain as there are in The USA. Spanish unemployment is now 17%, and rising. (Source: Variant Perception) Do you think the Spanish property market will carry on falling for years? Yes so do we.
2. Since 1900 to 2009, the real rate of return on equities (above inflation) is 0.4% pa. (Source: Credit Suisse) Did you expect it to be 5 or 10% pa? OK, it doesn't include dividends. Still, it's unsurprising when most people believe what the marketeers have told them – invest in stocks and you'll be OK. [Didn't they say that about housing too?]
3. Prof David (Danny) Blanchflower, retiring member of the interest rate setting Monetary Policy Committee, expects 100,000 extra unemployed PER MONTH between now and the rest of the year. Estimates of unemployment by next year lie at around 3.5 millions. Do you believe house prices will recover soon? No, neither do we. [No trend follows a straight line]
4. The US stock market shot up c 40% from early March to end May 2009. Of course it fell by more than a half from the end of 2007 to March 2009. Do you think the worst is over? No, neither do we. Green shoots? Have you seen government debt? Household debt? Banks loans?

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Caught by the Budget tax trap?

Alistair Darling's second Budget contained more than the usual share of surprises. Although last November's Pre-Budget Report (PBR) had seemingly trailed most of the spring Budget's content, the deterioration in the UK's economic condition since last autumn forced the Chancellor to strengthen some of his tax-raising measures.

The major surprises revolved around the new top rate of income tax. This was set out in the PBR as 45% for income above £150,000 from 2011/12. The Budget proper increased the rate to 50% (42.5% for dividends) and brought forward its start to next tax year. In parallel with this, the Chancellor revealed restrictions on higher rate tax relief for some pension contributions – so 50% relief will never be obtainable – as explained below in 'Higher rate relief melts away'.

From 2010/11, the new 50%/42.5% rates will also apply to all income of discretionary and accumulation trusts above the standard rate band.

The phasing out of the personal allowance for high income individuals was another PBR proposal that was amended to provide more revenue for the depleted government coffers. From 2010/11, your personal allowance will be reduced by £1 for each £2 by which your total income exceeds £100,000. The example at right shows how this will operate in practice.

Now is the time to start reviewing your affairs if you could be caught by these changes to income tax. For example, it could make sense to *increase* this year's income because the top tax rate is still 40% in 2009/10. You may also want to consider rearranging investment holdings to move income between you and your spouse or civil partner – independent tax planning now matters even if you are both higher rate taxpayers.

The value of tax reliefs depends on your individual circumstances and may be subject to change in the future.

Losing the personal allowance

In 2010/11, Stephen has a total income of £108,000. Assuming the basic personal allowance is £6,475, Stephen's allowance will be:

	£
Basic personal allowance	**6,475**
Reduction:	**4,000**
Remaining allowance	**2,475**

If Stephen receives another £2,000 of income during the year, he will pay tax on an additional £3,000 because he will lose another £1,000 of his personal allowance.

The effect is to increase his marginal tax rate by half, to 60% – higher than the new top rate. Only once his income exceeds £112,950 and his personal allowance is fully extinguished will he return to being a 40% marginal rate taxpayer.

ISA limits finally on the rise

One welcome surprise to emerge from the Budget was the increase to individual savings accounts (ISA) investment limits. When ISAs appeared in April 1999, the initial maximum total contribution was £7,000 per tax year. It was not until 2008/09 that this was improved – to £7,200. The increase announced in the 2009 Budget was a more useful £3,000, bringing the maximum total ISA investment to £10,200 per tax year. The corresponding limit for the ISA cash component has also risen, to £5,100.

The way in which the new limits will operate is not straightforward. Unless you were born before 6 April 1960, the new £10,200 ISA ceiling will not apply to you until 2010/11. The higher limit will be available from 6 October 2009, if you are aged 50 or over by the end of this tax year.

At a time when the taxes are increasing, ISAs offer one of the easiest ways to reduce the taxman's slice of the return from your investments.

There is another non tax-saving ISA feature that can be valuable in terms of time (and accountancy costs): nothing to report on your tax return.

Past performance is not a reliable indicator of future performance. The value of investments and income from them can go down as well as up, and you may not get back the original amount invested. Levels and bases of, and reliefs from, taxation are subject to change and their value depends on individual circumstances.

ISA feature	Maximum tax savings
Any income generated does not figure in any of the total income calculations for the new pension tax relief rules or next tax year's phasing out of the annual allowance	60% from 2010/11 if income falls into the band where the personal allowance is phased out
Interest from deposits in cash ISAs and from fixed interest securities in stocks and shares ISAs is free of UK tax	50% from 2010/11 for a new top rate taxpayer
For stocks and shares ISAs, there is no additional UK tax on dividends, although the 10% tax credit cannot be reclaimed	32.5% from 2010/11 for a new top rate taxpayer
All gains are free of UK capital gains tax	18%

Covering long-term care

People in need of long-term residential care are expected to pay for it in full, unless they have extremely limited amounts of capital and income. And capital often includes the value of their former home. Local authorities carry out financial assessments and individuals are charged what their local authority determines they can afford.

For 2009/10, the allowances and limits are:

- The local authority assigns a weekly personal expenses allowance (PEA) from the resident's income of £21.90. Residents must use their capital to contribute to the total cost of their care until their capital reduces to £23,000.
- Once a resident's capital reduces to £14,000, no further contribution is necessary.
- Between £23,000 and £14,000 the local authority will assess a 'tariff income' from the capital. It will take into account, as weekly income, £1 for every complete £250, or part of £250, of capital over £14,000.

The capital value of a resident's home counts towards these limits, unless the property continues to be the home of their spouse, civil partner or certain relatives. The value is disregarded for the first 12 weeks after admission into the care home.

An immediate care plan can be a useful option when an individual needs care because it can effectively limit the amount of capital spent on care fees. Immediate care plans are a type of annuity and provide an income, level or index linked and guaranteed for life, in return for a lump sum payment.

A major advantage of an immediate care plan is that it is underwritten. The health of the individual is assessed to estimate their life span actuarially. Many care home residents have a shortened life expectancy due to illness, so the rates offered can be attractive. The plan will continue to pay out until the individual no longer needs care.

To purchase an immediate care plan, an individual must already be in need of care. If they die, unless the plan specifically provides otherwise, there is no payment from the insurance company and the payments stop.

When care is needed, immediate care plans should be considered, even if only for part of the fees. They can help to give peace of mind over paying care home fees during what is often a particularly stressful time.

This is an area where personalised advice is essential.

Did you know that from 1 April, National Savings and Investments worsened the terms for premium bonds? It was the first change since January. The prize fund interest rate was cut from 1.8% to just 1% and the minimum prize – which accounts for over 96% of all prizes drawn – was halved to £25. The odds of winning were kept the same – 1 in 36,000 – but there is now only a single one million pound prize each month.[1] Premium bonds now look a poor bet, even for higher rate taxpayers. The theoretical 1% net return is easily beaten by many internet instant access accounts. [1] *NS&I, Press Release 18/3/09*

Higher rate relief melts away

Last November, the Chancellor announced that the annual allowance, which effectively sets a ceiling for tax-relieved pension contributions, would be frozen for five years after next tax year's increase to £255,000. April's Budget marked a more serious two-stage attack on the same target.

From 2011/12, tax relief for all pension contributions will be at basic rate only, if your annual income is at least £180,000. If your income is £150,000 or more, then relief will be phased down from higher rate to basic rate at £180,000. From 22 April 2009, 'anti-forestalling' measures came into effect, designed to prevent you from making large one-off contributions before the 2011/12 restrictions arrive.

Broadly speaking, these interim rules will only affect you in 2009/10 if:

- Your income after normal deductions (other than the personal allowance and pension contributions) is £150,000 or more in the current tax year, 2008/09 or 2007/08; *and*
- There is an unscheduled increase in the level of regular (quarterly or more frequently) contributions to your pension arrangements that were in force before 22 April 2009; *and*
- Your total pension contributions from all sources during the tax year are more than £20,000 (the special annual allowance).

Where you meet all three criteria, then as a general rule in 2009/10:

- Any contributions in excess of your total regular contributions will be subject to a 20% tax charge if those regular contributions exceed £20,000.
- Even if your total regular contributions from all sources are under £20,000, then you will be subject to a 20% tax charge to the extent that your total contributions exceed £20,000.

The precise definitions of income, regular and total pension contributions are extremely complex – there are 13 pages of Finance Bill legislation.

If there is one lesson to be drawn from these changes, it is the change in the value of higher rate tax relief where it remains available. In the pre-Budget era, it was taken for granted. Now, it's a case of 'You don't know what you've got till it's gone'.

Levels and bases of, and reliefs from, taxation are subject to change and their value depends on individual circumstances.

Protecting your business

For both limited companies and partnerships, it is extremely important for a business to protect its assets through insurance (for example, buildings, machinery and company cars). However, many businesses ignore their insurance requirements as far as the individual owners themselves are concerned. This may prove to be a false economy.

Consider the situation where three partners carry on a trading business. That business will have a value and if one of the partners were to die what would be the outcome?

His or her partnership share would normally pass according to the provisions of their will (it is very important for business people to have a will). This means that their share in the partnership would almost certainly be left to one or more members of their family.

The problem is that it would be a rare event if the beneficiary is able to take over the role of the deceased in the partnership. Also, would the other partners find that individual acceptable to them as a fellow partner?

Ideally, the partnership share of the deceased should go to the remaining partners and the monetary value should end up with the family members.

It is unlikely that the surviving partners would be able to afford to buy the partnership share of the deceased without borrowing some or all of the funds required. And what if the new owner did not wish to sell?

There are a couple of ways of approaching this potential problem. One is for all the partners to agree in writing that, should one of them die, the remaining partners have an enforceable option to buy that deceased partner's share from the beneficiaries and indeed that the beneficiaries have an enforceable option to sell it to the remaining partners. To make certain the funds are available when required, each partner should insure their life in trust for the benefit of the other partners.

The importance of undertaking this type of arrangement cannot be over-emphasised to ensure the smooth continuation of the business if a partner dies. Shareholding directors of private limited companies are in a similar position as partnerships, and are encouraged to make similar arrangements.

We can help you to make the necessary agreement and discuss the level of life assurance needed. Please call us.

The Financial Services Authority does not regulate the writing of wills and some forms of estate planning.

Did you know that the Retail Prices Index (RPI) dropped dramatically from its September 2008 peak of 5% pa to -1.2% pa by April 2009? This is a direct result of the 'credit crunch'. Do not assume, however, that all prices have dropped, because some have increased. The RPI is greatly distorted by the inclusion of mortgage costs that, due to the collapse of interest rates, have become much cheaper. For many people, especially those without a mortgage, a more relevant figure is the Consumer Prices Index (CPI). This dropped from 5.2% to 2.3% over the same period.

Capital gains exemption limit rises

The Budget announcement that the capital gains tax (CGT) annual exemption for 2009/10 is £10,100 was very welcome. It is important that those who are in a position to realise capital gains in this tax year consider doing so.

The effect of the 'credit crunch' on equity-based investments is that different sectors of the market may be more successful in showing capital growth in the future. It is therefore a good time to examine existing portfolios and make decisions on whether to adopt a change of strategy.

For married couples or civil partners, the exemption can effectively be doubled because each individual receives their own exemption. To take advantage of this, some investments may have to be transferred between spouses/civil partners so that each has sufficient gains to use their full exemption. Such transfers, although they are 'disposals', can be made without triggering a capital gain as they are deemed to be made on a 'no gain/no loss basis.

If the increased CGT exemption is not used in this tax year, it is lost forever.

Levels and bases of, and reliefs from, taxation are subject to change and their value depends on individual circumstances. The Financial Services Authority does not regulate tax advice.

Cap on age allowances

Anyone entitled to higher levels of income tax allowances for the year 2009/10, because of their age, should look at their financial situation if their total income exceeds £22,900. Once incomes are over that level, the age allowance reduces by £1 for every £2 of total income, until it drops to the basic allowance. For those caught in this 'trap', and leaving aside the married couples' age allowance, the related excess income suffers an effective income tax rate of 30%.

For those aged 65 to 74, the personal age allowance for this year is £9,490. It drops to the basic allowance of £6,475 once total income reaches £28,930.

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