Watson French
INDEPENDENT FINANCIAL PLANNING
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THE BUDGET/ ELECTION AFTERMATH

This year's spring Budget – which is now due to have a summer follow-up on 8 July – was an unusual affair. The looming general election meant that the Chancellor's performance was even more of a political stage show than normal. Indeed, some of the announcements seemed to be purely poll-driven, such as the unexpected review of deeds of variation, used (by Ed Miliband, among many others) to restructure wills post-death.

Adding to the slightly surreal nature of the Budget was the fact that the Finance Bill, which puts the Budget into law, was destined to be rushed through in just a few days, before parliament closed down and electioneering proper started. The result was that not everything the Chancellor said in his Budget speech reached the statute book. Similarly, some of the proposals in the Conservative manifesto also arrived too late for the Chancellor's March presentation.

What follows is a brief summary of where we are now and what is likely to be in place for next April.

Income Tax

Much of what the Chancellor said in the Budget was predictable, although there was one surprise:

- The personal allowance was increased by £200 to £10,800 for next tax year (2016/17) and another £200 to £11,000 for 2017/18, changes which made it into the Finance Act.
- Future increases in the higher rate threshold (currently £42,385) were also legislated for: to £42,700 in 2016/17 and £43,300 in 2017/18.
- The rabbit-out-the-hat Budget measure which did not become law was a personal savings allowance, due from 2016/17. If you are a basic rate taxpayer, this will allow you to receive up to £1,000 of savings income (broadly speaking, interest) free of tax – a maximum tax saving of £200. The same tax saving applies if you are a higher rate taxpayer, so your maximum slice of tax-free savings income is £500. Additional rate taxpayers will not receive any allowance. A corollary to the introduction of this new allowance is that all bank and building society interest will be paid gross (without deduction of tax) from 6 April 2016.

The Conservative manifesto promised that by 2020/21:

- There will be no increase in income tax (or National Insurance contribution) rates;
- The personal allowance will be £12,500; and
- The higher rate threshold will be £50,000. This may sound a useful increase, but in fact the threshold was £43,875 as long ago as 2009/10.

Inheritance Tax (IHT)

The Budget revealed only a few technical changes to inheritance tax which reached the Finance Act, but the Conservative manifesto promised a new main residence allowance of £175,000, transferable between spouses and civil partners, even if the first death had already occurred when the new allowance comes into being.

The detail on this is still to emerge, but the broad plan is currently for the allowance to be phased out at the rate of £1 for each £2 by which an estate's value exceeds £2 million, ie there would be no allowance above £2.7 million for a couple. The idea was criticised as overly complex and discouraging property downsizing. It is possible that, free from coalition constraints, Mr Osborne will now instead increase the nil rate band to £500,000. This would cost little more, produce a very similar result and have the added virtue of simplicity.

This potential change means that for the time being estate planning has been complicated somewhat and that, once legislation is in being, your estate planning may need to be reviewed. It is worth remembering that the nil rate band has been £325,000 since April 2009, so part of any increase would merely represent catching up with inflation – especially in terms of house prices.

Capital Gains Tax (CGT)

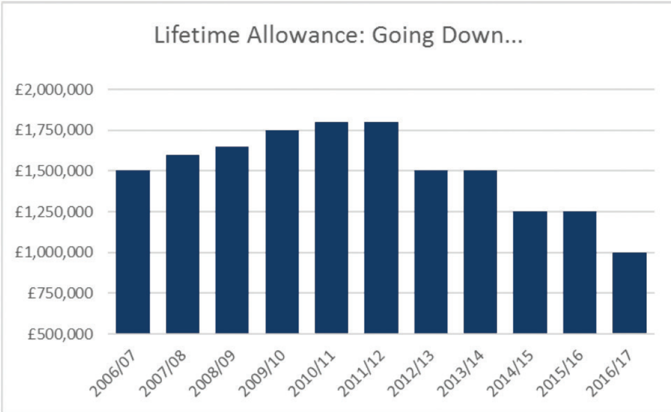
CGT was one tax where there was a strong threat of a post-election rate rise. Instead we have an annual exemption of £11,100 for 2015/16 and very little chance of a rate increase. However, capital gains tax is an area the Chancellor may seek some additional revenue from – it is not one of the three taxes that were subject to the no-increased-rates pledge. The cost of entrepreneurs' relief is much higher than the Treasury had anticipated and while there were some technical amendments made by the Finance Act, it is possible major reform will emerge in the near future.

Pensions

As if there had not been enough changes to the pension tax rules of late, the Budget announced that the lifetime allowance - effectively the maximum tax-efficient value of pension benefits – would be cut by 20% to £1 million from 2016/17, the third cut in six years (see graph below). Strangely enough this measure did not appear in the Finance Act, even though the Labour Party had proposed the same reduction. £1m may sound a substantial amount, but on current index-linked annuity rates it will only buy you about £25,500 a year of pre-tax income at age 60 and £32,500 at age 65.

The Chancellor promised another set of transitional protection rules for those affected, but gave no details. It is presumed these will follow the same principles as applied to the 2014 protection options, one of which can still be claimed.

In the Conservative manifesto a further attack on pensions was promised, with a reduction in the annual allowance – the maximum effective tax-relieved annual contribution – if your income is



over £150,000.

Alongside the Budget the Treasury issued a consultation paper on proposals to allow existing pension annuities to be sold in exchange for (taxable) cash or another type of pension benefit. The logic behind this is to allow existing annuity owners to enjoy the same flexibility as the pension reforms have given to those not yet drawing benefits. However, this may not be as simple as it sounds – for a start the Treasury does not want providers buying back their annuities, so there would have to be a third party purchaser involved.

Individual Savings Accounts (ISAs)

Two changes to ISAs were announced in the Budget, although neither reached the legislative stage. The more newsworthy – with a definite election tinge – was the proposal for a Help to Buy cash ISA. This would give a 25% bonus for all savings applied by a first-time buyer to purchase a new home worth up to £450,000 in London and up to £250,000 elsewhere. The maximum investment in this ISA would be £1,000 initially and £200 a month thereafter.

The maximum bonus will be £3,000, which would require £12,000 of savings – about four and a half years' savings at the current limits. The minimum bonus is £400 (on savings of £1,600), so as the scheme is not due to start until autumn the first payments will not emerge until 2016. Unless the proposals are revised, one trap to watch for is that contributing to a cash ISA now could mean that a Help to Buy ISA is off limits until next tax year. The problem is that, as things stand, you are only allowed to contribute to one cash ISA per tax year and transfers into Help to Buy ISAs will be restricted to the maximum contribution payable from the start of the scheme.

The other change to ISAs, due from 2016/17, reflects the proposed introduction of the personal savings allowance. The practical effect of this allowance is to render cash ISAs largely redundant as most people will be able to receive deposit interest with no tax liability and none of the constraints that apply to ISAs. The Chancellor therefore proposed that from next April you will be able to withdraw money from a cash ISA and replace it within the same tax year without the replacement sum counting as a fresh contribution.

ACTION

The Budget has and will make a number of changes to tax rules. So too will the Conservatives' manifesto pledges, assuming that they are implemented – and there is now no we're-in-a-coalition excuse for not doing so.

Although many of the changes are delayed until next year, that does not mean you should not start planning now. In particular, if you could be affected by either of the cuts to the main pension allowances, you should talk to us as soon as possible.

ISA CHANGES FROM APRIL 2015

Two changes took effect to the ISA rules from 6 April. Both had been well trailed, but neither was certain to come into being because of the end-of-parliament rush to pass outstanding legislation.

Transfers from Child Trust Funds to Junior ISAs

Child Trust Funds (CTFs) were one of the first casualties of the coalition government's efforts to reduce government expenditure. Until 2 January 2011, a payment of £250 or £500 was made by the government into a CTF on a child's birth. Once that stopped, CTFs were left in limbo, with only personal contributions possible (then up to just £1,000 a year) and no new plans available. In November 2011 Junior ISAs (JISAs) were launched, but children with CTFs were excluded from having a JISA. The annual contribution limit for JISAs (and CTFs) was set at £3,600 and has since risen to £4,080 for 2015/16. The introduction of the JISA prompted calls for the two schemes to be merged, but for various reasons the Treasury held back. A transfer from a CTF to a JISA is now an option – it does not happen automatically. In practice, it is a move worth exploring as the financial world has moved on since CTFs were launched in 2005 and a JISA could well offer more investment choice and lower costs than a CTF.

Inheritable ISAs

In last year's Autumn Statement the Chancellor announced that for deaths on or after 3 December 2014, the survivor of a married couple or civil partnership would be able to 'inherit' the ISA of their deceased partner. As is often the case, what was said and what has eventually emerged are not quite the same. The structure adopted by the regulations is to allow the survivor to make an additional ISA contribution (in cash and/or the deceased's ISA investments) equal to the value of the deceased's ISA at the date of death. Given the time it can take to obtain probate, the result will generally not be the same as simply changing the name on the deceased's ISA – values will move in the interim.

Nevertheless the change is a beneficial one. ISAs are of growing importance for retirement income planning, not least because of the increasing constraints on pension provision. There is also an argument for saying that pension monies are best left untouched as long as possible, given their current general exemption from inheritance tax.

ACTION

If either of these reforms could be relevant to you or your children/grandchildren, now is the time to review matters. With further changes due on pensions, as we explain elsewhere, you may want to review your entire retirement strategy.
If you have cash ISAs, talk to us about their relevance in the light of the forthcoming personal savings allowance. With some interest due to be tax-free outside an ISA, where you hold which investments may need to be revisited.

INFLATION AND INTEREST RATES

The deal

Here's the deal: you lend the German government €100 for 10 years and it pays you interest of 5c a year. To save your scrabbling for your calculator/smartphone, the offer equates to an interest rate of 0.05%. Over the ten years of the loan you would earn total interest of half a euro.

To put it mildly, it does not sound very attractive, but in mid-April that was all some investors accepted for giving their money to Germany for a decade. At least the return was positive – at the time a large slice of shorter term Eurozone government debt was offering negative interest rates – you were paying to lend to the government.

In the UK – and outside the Eurozone – yields generally did not drop as far. Nevertheless, in mid-April the Treasury was able to borrow for 30 years – out to 2045 – at a cost of just under 2.35%.
Within a few weeks the picture changed dramatically and 10 year German bonds were yielding over 0.6% – 12 times as much – while the UK 30 year borrowing cost had risen to 2.65%.

An explanation?

Why yields have dropped so low has been a puzzle. Some experts blame the actions of the European Central Bank, which is at present set on spending €60bn a month on buying mostly government bonds until September next year. Others say it is down to very low inflation and poor economic growth prospects. A third argument has been that some investors – such as pension funds – are under regulatory pressure to buy bonds, regardless of price, to match their liabilities.

None of these explanations can also explain why there was such a bounce back in yields after mid-April. Nor do they give a clue as to whether we have now seen the low point for interest rates after decades of decline.

What about UK interest rates?

If you are looking to invest for income, movements in bond yields are one of the factors which determine how much income you will receive. The effect may not be direct, but the global nature of financial markets means that ripples from Germany – or the USA – can reach the UK's shores.

The latest indications from the Bank of England in its May Quarterly Inflation Bulletin is that it agrees with the money market's current view, ie the first rate rise will be early next year and that three years from now base rate will be a shade under 1.5%. You could be forgiven for thinking that the prediction of "an increase next year" is one that has been repeated for some years already. For now there is no obvious reason to increase rates: inflation is low (In fact it is deflation of 0.1% based on April's CPI data) and the economy shows no signs of overheating, outside of certain parts of the housing sector. But as the Bank's Governor, Mark Carney, said of his forecasts, they "will inevitably be buffeted by domestic and international shocks".

ACTION
If you are looking for income from your capital, the recent volatility in bond yields is a useful reminder that, in today's markets, sharp price movements are possible.

Talk to us about your income options and how your portfolio can be structured to offer some protection against Mr Carney's inevitable buffeting.