

**ROUSE**

I N D E P E N D E N T F I N A N C I A L A D V I S O R S R O U S E L I M I T E D

NOW THAT THE DUST HAS  
BEGUN TO SETTLE .....

Enjoy the  
Freedom of  
Financial Security

## ● INTRODUCTION

Now that some (but by no means all) of the pre-Budget dust has settled we are pleased to set out some of our thoughts on some of the issues and opportunities arising that you might care to consider.

If any of the subjects we discuss in this newsletter are of interest to you please contact us.

## ● PERSONAL ALLOWANCES AND RELIEFS

The standard personal allowance has been increased to £5,035 and age allowance for persons aged between 65 and 74 inclusive increases to £7,280 and to £7,420 for those aged 75 and over.

The income threshold for age allowance increases to £20,100.

### Action to consider .....

The standard personal allowance is non-transferable. Whilst it is not possible to transfer the personal allowance, if you are married or in a civil partnership and one of you is a non-taxpayer it may be possible to ensure that income (especially investment income) is received between you and your spouse/civil partner so that full use is made of both of your personal allowances. Sometimes a transfer of income-producing assets will facilitate this "income transfer". Remember, though, that there is no tax credit reclaim in respect of any dividend income received by a non-taxpayer regardless of whether the dividends come from private company shares or publicly quoted shares.

Age allowance applies separately to a husband and wife and civil partners, as does the total income limit of £20,100 above which the allowance reduces by 50p for every £1 that total income exceeds £20,100. By careful planning it may be possible for both spouses/civil partners to qualify for age allowance. When income exceeds the £20,100 threshold, each £1 of income (until the higher allowance reduces to the level of the standard personal allowance) is effectively taxed at a rate between 30% and 33% depending on the type of income involved. This is because as well as suffering tax at the basic rate of 22% or the 20% lower rate (as appropriate) it also causes 50p (ie the lost age allowance) of income to bear tax at up to 22%. This means that the total extra tax suffered by virtue of each extra £1 will, in most cases, be 30p and can sometimes be 33p.

If this is relevant to you, (and subject to capital gains tax considerations), reinvestment in non-income producing assets should be considered. Capital investment bonds and capital growth oriented unit trusts may be attractive as, (subject to guarding against capital erosion), "income" can be taken without loss of age allowance. ISAs are also attractive as income is not taken into account for age allowance purposes.

If you are a partner or shareholding director and have a credit balance loan account or capital account and a mortgage then it may pay you to consider using any available cash within your business to repay what the business owes you so that you can (subject to the usual commercial considerations) repay any borrowings, the interest payable on which is not relievable for tax purposes. Remember that since 6 April 2000 there has been no tax relief on mortgage interest paid in connection with home purchase.

To the extent that funds may be needed by the business in the future (the loan account or capital account having been repaid to facilitate the mortgage repayment) then a further loan could be arranged by you, possibly secured on the same property, but interest payable would normally be deductible the loan having been taken to provide funds to the borrower's business. Professional advice is always essential before entering into any such transaction.

## ● THE RATES OF INCOME TAX

There has been no change in the higher rate of tax, which remains at 40%. The 10% rate of tax (on the first £2,150 of taxable income after allowances and reliefs for 2006/07) continues to apply to all types of income.

The basic rate of tax remains at 22% (for 2006/07) and the threshold above which the highest rate of tax - 40% - applies is increased to £33,300.

Savings income which falls within the band £2,151 to £33,300 continues to be taxed at 20%.

### Action to consider .....

You should, if you are married or in a civil partnership, carefully consider the allocation of income between you and your spouse/civil partner. This allocation, and the consequent tax saving, can be achieved by transferring assets (usually investments) unconditionally from the higher taxpayer to the lower or non-taxpayer.

If you are a higher rate taxpayer, consider investment in tax free or tax-sheltered investments. We cover this in more detail later.

## ● NATIONAL INSURANCE

### Employees and Employers

Changes to thresholds and allowances are being made for 2006/07, but the rates remain the same.

#### (a) Employees:

From April 2006 employee NICs of 11% are payable on earnings between £97 per week and £645 per week.

In addition, all earnings over £645 per week will continue to bear primary Class 1 NICs at the rate of 1%.

#### (b) Employers:

From April 2006 the employer's rate of NIC is 12.8% in respect of earnings over £97 per week.

As far as employers are concerned, it is worth remembering that employer's Class 1A NICs cover benefits in kind that are subject to tax, such as private medical insurance, and not just cars and car fuel. This diminishes the attraction for the employer of paying employees by means of benefits in kind. Employees do not pay NICs on benefits in kind.

### Action to consider .....

Many employers and employees understandably consider NICs to be part of the tax system – they are deducted at source and diminish take-home pay in the same way that income tax does. As such they are keen to consider action that could reduce their liability. To achieve this a thorough review of remuneration policy should be undertaken. This should take full account of the best way of extracting benefit from a business - the key choices remaining as dividend, salary or pension.

It can be tax/NIC attractive for employees to sacrifice remuneration with the sacrificed amount being applied as a pension contribution by their employer. The attraction can be further increased if the employer is prepared to apply all or part of their saving in NI contributions as an additional contribution to the employee's pension plan.

The following example may help to demonstrate this. It illustrates the position of an employee with a salary of £50,000 in tax year 2006/07 and shows the effect of a £5,000 salary sacrifice.

	Before £	After £
Gross income	50,000	45,000
Income tax	11,734	9,734
Employee NICs	3,300	3,250
	-----	-----
Employee disposable income	34,966	32,016
	-----	-----
Employer NICs	5,754	5,114

The pension benefit to the member is:

£5,000	Employer contribution (as a result of the sacrifice)
£ 640	Employer NIC saving
-----	
£5,640	
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This pension benefit has been achieved at a cost of only £2,950 in disposable income of the employee.

There are several important points to remember concerning salary sacrifice.

- (i) For a salary sacrifice to be effective it must be made before the remuneration being given up is treated as having been received for tax purposes. For an employee, this will normally be the earlier of the date the payment is made, and the time the individual becomes entitled to the payment.

- (ii) Where a company director is concerned the following additional dates also need to be considered:
  - The date when remuneration is credited in the company's accounts or records.
  - Where the remuneration is determined during the course of a company's accounting year (or other period in respect of which the remuneration is paid) it is deemed to be paid at the end of that year or period.
  - Where the amount of remuneration is determined after the end of the period to which it relates, the date the amount is determined.
- (iii) Where there is any doubt as to the date a director's remuneration becomes assessable to tax as employment income this should be checked with the company or the director's accountant.
- (iv) Some self-employed people may even consider that the potential to avoid the additional 1% Class 4 NIC charge on all profits above the upper profits limit of £33,540 per annum is enough to warrant serious consideration being given to incorporation and a remuneration strategy founded on NIC free dividends. Of course, many other issues would need to be considered before taking this step and professional specialist advice would be essential.

## The Self-Employed

From April 2006, Class 4 NICs of 8% will be payable on profits between £5,035 per annum and £33,540 per annum. In addition, all profits over the upper profits limit of £33,540 per annum will continue to bear NICs at 1%.

The Class 2 flat-rate contribution is kept at £2.10 per week, and becomes due when profits exceed £4,465 per annum.

## ● CAPITAL GAINS TAX

Basic rate taxpayers will continue to pay capital gains tax (CGT) at 20% up to the higher rate threshold. Higher rate taxpayers (ie taxpayers whose other income exceeds the higher rate threshold) will pay tax at 40%.

The annual exemption has been increased to £8,800 for tax year 2006/07. Remember the annual exemption is available for each of a married couple/civil partners.

This exemption remains as one of the most important weapons in an individual's CGT planning armoury. Each individual (in a family this means you, your spouse/civil partner and each child) can realise gains each tax year within his/her annual CGT exemption tax free.

A simple way for parents and grandparents to facilitate use of the exemption by children under the current law is for investments, such as unit trusts or OEICs, to be held for the designated benefit of the child. All capital gains would then be assessed on the child not the parent or grandparent.

It may be that in the future capital gains made from the disposal of assets held in this way will be assessed on the settlor if the beneficiary is his or her unmarried minor child who is not in a civil partnership. This is something that has been raised in the past by Her Majesty's Revenue and Customs in the context of the reform of the taxation of trusts. However, to date no change in this area has been announced.

Transfers between spouses/civil partners living together will not trigger a CGT charge so, as long as any transfer is outright and unconditional, a prior transfer to your spouse/civil partner could potentially double the overall use of the family's annual exemption. Since 1998 it has been much harder to use up the annual exemption through "bed and breakfast" transactions but certain other planning routes still exist in the form of "bed and spouse" and "bed and ISA" transactions.

## Taper relief

Taper relief remains with us, undiminished by any proposals in this year's Budget.

The general principle of taper relief is that it operates to give rise to a gradual reduction in the amount of capital gain subject to tax according to the period for which the asset has been held after 5 April 1998. For non-business assets, all of the capital gain on the sale or gift of an asset is taxable with less than 3 years of ownership. For 3 years of ownership 5% relief is available and a further 5% for each complete year for which the asset is held up to 10 years. This means that if an asset has been held for 10 or more years only 60% of the capital gain will be chargeable to tax. In turn, this means that a 40% higher rate taxpayer would pay a maximum effective rate of tax of 24%, while a basic rate taxpayer would pay a maximum effective rate of tax of 12%. People owning assets on 16 March 1998 are credited with an extra one year of ownership.

Far greater taper relief is available for business assets. For disposals taking place after 5 April 2002, after one year's ownership only 50% of the capital gain will be chargeable. This falls to 25% after 2 years. This means that the effective rate of tax payable on gains made on disposal of business assets by a higher rate taxpayer will be 20% after one year's ownership and 10% after two. All shareholdings in unquoted trading companies, all shareholdings held by employees in quoted trading companies and shareholdings held by outside investors in quoted trading companies which carry at least 5% of the voting rights will qualify for business assets taper relief as well as certain assets owned by an individual and used in a trade.

## Which means that .....

The availability of taper relief for investments makes it a good time (for tax purposes) to consider the relative tax merits of the various tax efficient collective investments, such as unit trusts, OEICs, investment trusts and appropriate offshore funds, where the underlying investments are designed primarily for capital growth. The combination of taper relief and the annual exemption can operate to, in effect, "stretch" the annual exemption and/or substantially reduce the effective rate of tax payable on capital gains. For example, if an investment had been held for 10 years since the introduction of taper relief and a gain of £14,666 was made, taper relief would operate to reduce the gain by 40% to £8,800, which (based on the new level of the annual exemption) would be wholly exempt from tax.

Even where the annual exemption has already been used, taper relief can operate to reduce the effective rate of tax to 24% for higher rate taxpayers and 12% for basic rate taxpayers. Of course, investment decisions should never be made on tax grounds alone. The power of reinvested income in driving long-term real growth is undeniable.

It will be absolutely critical to take this into account in determining the investment balance that is most appropriate for an investor.

If you are married or in a civil partnership and between you and your spouse/civil partner the gains on your investments exceed £17,600 you should consider carefully splitting your investments between you and your spouse/civil partner so as to make maximum use of each annual exemption.

If you have grandchildren and you wish to pass on cash/investments for their benefit, you could consider establishing a suitable trust for their benefit. Depending on the type of trust used it may be possible, under the current law, to either use the grandchild's full annual exemption of £8,800 or at least create an extra trust exemption of, normally, £4,400. Growth unit trusts and OEICs can be an ideal way of investing within a trust to utilise the annual exemption.

## ● INHERITANCE TAX

The Chancellor made three important announcements on inheritance tax, as follows:

- (i) The nil-rate band, the starting threshold for inheritance tax, will increase in stages to £325,000 for tax year 2009/10. For tax year 2006/07 it will increase to £285,000.
- (ii) The current rules that apply as regards the inheritance tax treatment of lump sum death benefits paid out of pension schemes will continue to apply.
- (iii) There will be a substantial change in the inheritance tax treatment of payments made to certain trusts and the way those trusts are dealt with for inheritance tax in the future.

## Which means that .....

Given the fact that a greater number of people are now fully within the IHT net, it is important to make maximum use of all the planning strategies available, in particular:

- (i) The nil-rate band (the cumulative total of non-exempt transfers that can be made by a person without triggering a liability to inheritance tax) increases to £285,000 from 6 April 2006 with a flat rate of tax on death of 40% over that amount. For a person with assets over £285,000 the increase in the level of the nil-rate band will produce a potential increased inheritance tax saving of £4,000.
- (ii) The annual exemption, which is kept at £3,000. This exemption is available to each individual.
- (iii) You (and your spouse/civil partner) should seriously consider making full use of the IHT exemptions/reliefs available under the current rules, the main features of which are as follows:

- An outright gift of any size between individuals will be a potentially exempt transfer (PET), which means that the gift is exempt from inheritance tax if the donor survives the gift by 7 years.
- For those who want some ongoing control a gift of up to the current available nil-rate band into a trust will not suffer any IHT at outset. Although an IHT charge can arise when property later leaves the trust, or on a 10 year anniversary, any such charge is unlikely to be substantial as the maximum tax charge is currently 6%.
- A 100% maximum level of business property relief and agricultural property relief.
- The availability of certain lump sum insurance-based inheritance tax schemes that can provide you with "income" and inheritance tax mitigation but without the gift with reservation rules or the pre-owned assets income tax charge applying. It is understood that some life offices are reviewing their schemes in light of the proposed IHT changes to trusts but those schemes should become available again in due course.
- Advantageous rules for excluded property trusts which benefit non-UK domiciliaries.

## Action to consider .....

You should review your Will provisions or (if you do not have one) seriously consider making one. There will often be relatively simple steps that you can take to ensure that you maximise the savings that can be secured for your intended beneficiaries. At current rates of tax, if the first of a married couple/civil partners to die is able to fully use the increased nil-rate band £114,000 could be saved on the death of the second to die. As you may have read, some of you will need to review your Will with especial care as, in some cases, if implemented in the form that it is in, eg if it leaves an initial interest to your spouse but gives trustees a wide power to appoint benefits, it could incur unplanned for and unwelcome charges under the IHT discretionary trust regime.

Gifts made during your lifetime can be extremely effective in reducing the ultimate inheritance tax liability but care is necessary to ensure that the desired savings are achieved. If you own business assets you may, subject to all the very important considerations, wish to make a gift whilst 100% business property relief and agricultural property relief is available. If you are contemplating making substantial outright lifetime gifts in order to save inheritance tax you should do so whilst PET treatment is available. All growth in the value of the gift will be free of inheritance tax. However, there is also the fact that if no gifts are made there will be an uplift in the value of the assets on death which means that capital gains up to the date of death are "washed out". This must be taken into account in decision making.

Gifts to most new trusts now count as chargeable lifetime transfers, for example an accumulation and maintenance trust and a power of appointment interest in possession (flexible) trust. This means that in order to avoid an immediate IHT charge, such gifts should not cause the donor to exceed his IHT nil-rate band (£285,000 for 2006/07) taking account of lifetime gifts made within the previous 7 years which are not PETs or exempt.

If you are married both you and your spouse/civil partner can take advantage of the nil-rate band.

Although there could be an IHT charge every 10 years and when capital leaves the trust, the maximum charge at that time would be 6% and, in many cases, much less than this or even nil.

By use of a trust, continuing control can be maintained by the donor acting as trustee and, in the case of the flexible trust, maximum flexibility can be included over who will be the ultimate beneficiary under the trust. A life assurance policy can be effected to cover any potential inheritance tax liability on the death of the donor within 7 years.

Careful consideration needs to be given to the capital gains tax implications of making gifts and the capital gains tax cost of making a gift balanced against the potential inheritance tax saving. Following the changes made in this year's Budget, it will, in general, be possible to defer CGT on gifts of investments to all trusts using hold-over relief.

If cash gifts are to be made into trust, insurance-based investment bonds and other non or low income producing investments can be an attractive trustee investment on tax grounds. This is especially so as the rate of tax applying to trust income and gains is 40% (32.5% on dividends).

For any lifetime gift to be effective for inheritance tax, it is generally necessary for you (the donor) to be excluded from all benefit in respect of what you have given away. For example, if you give away investments you should not have access to their capital value or any income produced by them. It is the need to satisfy this condition that makes effective inheritance tax reduction difficult for many to achieve.

However, certain insurance company schemes seek to overcome this problem by providing you with an "income" whilst providing inheritance tax efficiency on investment growth outside your estate. Several schemes exist, which are unaffected by the gift with reservation rules and the pre-owned assets income tax charge, and their appropriateness will depend on your objectives and circumstances.

To the extent that the liability to inheritance tax cannot be reduced by planning, you could consider an appropriate life assurance policy subject to trust so as to provide tax free cash in the hands of the beneficiaries who will have to meet the liability. If you are married or in a civil partnership and all or most of the liability to inheritance tax will arise on the death of the survivor the recommended policy would be one that pays out at that time. Although, in theory, an IHT charge could arise on payment of the policy proceeds in many cases, because of the way IHT is calculated, no liability should arise.

The Government has confirmed that provided a person has acted primarily with a view to providing retirement benefits rather than paying death in service benefits to beneficiaries, there should be no IHT liability on lump sum death benefits paid under pension schemes before a person attains age 75.

The new inheritance tax rules in connection with trusts are complex and you will need advice before taking action. This will be true even in connection with a simple life assurance policy held in trust. You should feel free to contact us to discuss your options.

## ● THE SIMPLIFIED PENSIONS TAX REGIME

On 6 April 2006 the Government introduced the new simplified pensions tax regime. All the existing pension tax regimes for occupational pensions, personal and stakeholder pensions, and retirement annuity contracts have been swept away and replaced by one new tax regime.

The changes mean that everyone will need to review their existing pension provision in light of the changes and, where appropriate, take action in order to maximise their benefits.

So what are the key changes?

One new pensions tax regime applies to members of all approved schemes (henceforward to be called registered schemes).

All existing approved schemes (occupational, personal, stakeholder and retirement annuity contracts) are subject to the rules of the new tax regime.

A single Lifetime Allowance limiting the total amount of pension savings that can benefit from tax relief will be set. In tax year 2006/07 this is £1.5 million. This will be increased in each subsequent tax year as indicated by the Treasury.

Transitional rules enable members of existing occupational schemes, where appropriate, to protect their entitlement to pension and tax-free cash benefits secured prior to 6 April 2006.

Where the value of retirement benefits exceeds the Lifetime Allowance a charge of 25% is levied (55% where the excess is taken as a lump sum).

There is an annual limit of inflows of value to a member's pension funds. For tax year 2006/07 this is £215,000. This amount will be increased in each subsequent tax year as indicated by the Treasury.

The maximum member's personal contribution in each tax year is limited to the greater of £3,600 gross and 100% of earnings.

Up to 25% of the capital value of a member's benefits within the Lifetime Allowance may be taken as a tax-free cash sum. The balance will be used to provide taxable annuity or income benefits. There is no specific HMRC limit on the maximum pension/income that can be provided other than that available from the capital value of the member's fund within the Lifetime Allowance.

Where a member dies before drawing benefits a lump sum of up to the amount of the Lifetime Allowance can be paid free of inheritance tax to one or more beneficiaries. Where a lump sum exceeds the Lifetime Allowance, the excess will be subject to tax at 55% on the recipients of the death benefit.

Provision may also be made for a spouse/dependant's pension/income payments in the event of the death of the member before or after drawing benefits.

Benefits may be drawn from age 50 onwards (age 55 from 6 April 2010). A member may be able to draw their benefits in full or in part without having to retire from their employment. The latter is subject to whether the rules of your scheme permit such flexibility.

Employer contributions will normally be allowable as a business expense in the accounting period in which they are paid. Tax relief will be available on the member's own contributions at the member's highest rate(s).

The introduction of the new regime has raised many questions. These include:

- (i) What capital value will HMRC place on a member's retirement benefits when determining the Lifetime Allowance?
- (ii) Will it be advantageous for a member to elect for transitional protection of his/her retirement benefits? And, if so, would he/she be best advised to opt for primary or enhanced protection, or both?

As can be seen from this brief summary of the proposed provisions of the new simplified pensions tax regime many issues are raised. Professional advice is needed to fully explain the new rules and how these will affect pensions planning.

### Action to consider .....

You should review your existing pension arrangements and decide what level of income you will require in retirement.

Many people do not pay enough in pensions to achieve the income they require and rely on the State Pension. However, the Government continue to move the goal posts regarding State Pensions and are looking at increasing the pension age to 68 from 2044. If you do not want poverty in retirement, then sensible pension provision is a necessity.

If you have existing pension plans, it would be worth checking the charging structure. Newer style pensions have lower charges and you consider transferring to a Self Invested Pension Plan (SIPP) to offer greater investment flexibility.

If you are approaching retirement age, you should consider all the options that are available to you. Do not simply accept the annuity offered by your existing pension provider as there may be better options available to you. Seek proper financial advice to ensure that you are making the most of your pension savings.

This newsletter is provided for general consideration only so no action must be taken or refrained from based on its contents alone.

Accordingly, no responsibility can be accepted for any loss occasioned as a result of any such action or inaction.

Professional advice is absolutely essential before taking any action or refraining from action.

## Service .....

Rouse Limited is a company of independent financial advisors, which proudly offers the delivery of a highly professional and personalised service to clients across a broad range of product areas.

## Quality .....

It is our policy to formulate workable, tailor-made financial planning strategies that create and preserve wealth for clients, and to ensure all client needs and enquiries receive prompt and personal attention.

## Knowledge .....

All our advisors have studied and attained the highest level of qualification from the Chartered Insurance Institute in Taxation and Trusts (G10) and have experience in dealing with Trustees, Accountants, Solicitors and other Advisors. In addition, Ben Rouse holds the Advanced Pensions Certificate (G60). Tax efficient investing, retirement planning and portfolio construction is our speciality.

## Advisors .....

Ben Rouse – G10, G60  
Ben Silk – BSc (Hons), G10, MAQ  
Linda Boynton – G10 with Distinction

## For further information .....

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