LIGHTHOUSEGROUP

LighthouseGroup
26 Throgmorton Street
London
EC2N 2AN

T: 0870 1977 400
F: 0870 1977 499
www.lighthousegroup.plc.uk

FEATURE ARTICLE

Date: **14th July 2015**

Issued by: **Andrew Gadd, Head of Research - Lighthouse Group**

Summer Budget 2015 – The Devil is in the Detail

Now that, following the Summer Budget on the 8th July, the dust has settled, there are a few areas that I feel merit closer examination and explanation, after all invariably the devil is in the detail!

New Pension Trap?

The “headline” news was that for those earning more than £150k then from April 2016 the amount that they can contribute to a pension is reduced, on a tapering scale, down to a maximum of £10k per annum. This means that at an income level of £210k the maximum pension contribution, with tax relief, is just £10k.

On closer examination of the detail, however, it turns out that this reduction will potentially affect individuals with less than £150k income a year. This is because the calculation of “earnings”, as defined in this legislation, will include pension contributions as well as bonuses and investment income. The Treasury actually stated that: “The government will introduce a taper to the annual allowance for those with adjusted annual incomes, including their own and employer’s pension contribution, over £150k.” As a result, for example, a worker with a salary of £110,001 who adds £40k to their pension will be caught by the new legislation.

There is also the question with regard to this new legislation that for high earners, many of whom do not know how much they have earnt in a tax year until that year is nearly over, they may not, in fact, know what their pension contribution limit will actually be, based on the new taper rules, until after the tax year has finished?

Opportunity for Pension Planning before April 2016?

Due to changes to rules regarding pension input periods, announced in the Budget, savers have potentially been awarded an extra £40k allowance between now and the beginning of the new tax year in April 2016.

High earners who used up their 2015/16 £40k allowance before July 9th now have the ability to pay a total of £80k this tax year into their pension, provided they have sufficient earnings to attract tax relief in the current year. (Although if the £40k allowance was not used before the 9th July they will only have the usual £40k allowance this tax year. If however they used any of the £40k allowance before 9th July this will not count towards the £40k allowance available between 9th July and April 2016.)

In addition, of course, it is possible to carry forward any unused allowances from the previous three years. Last year the maximum contribution was £40k, while in 2013-14 and 2012-13 it was £50k. That means a saver could, potentially, pay as much as £140k on top of this year's allowance. (Remember however that as I have already explained, in order to benefit from carry forward tax relief earnings must exceed contributions – you cannot pay into a pension more than you earn in that year.)

Peer to Peer ISA:

A new ISA is to be introduced with the specific intention of investing in peer-to-peer lending. The "Innovative Finance ISA" will be available from April 2016. The government intends to publish draft legislation for technical consultation later this year, with a view to legislating to allow peer-to-peer loans to be held in an ISA from 6th April 2016.

It is important, however, to note the added risks of this investment.

The key reason a third ISA is needed (in addition to cash and stocks/shares ISAs) is because there is a different set of risks and investors need to understand this. The new ISA will not, for example, be required to allow withdrawal of investments within 30 days, a feature other ISAs provide, due to the illiquid nature of peer-to-peer loans and the fact that a secondary market for every loan cannot be guaranteed. In addition investors will not be covered by the Financial Services Compensation Scheme.

Investors will need to fully understand that although the returns on peer-to-peer lending may appear to be attractive, these potential returns come with added risks.

New IHT £1m Limit:

The headlines have focused on the fact that a new transferable nil-rate band will be introduced from April 2017. This will apply when a main residence is passed on death to direct descendants, such as a child or grandchild. The allowance will be up to £100,000 in 2017-18, up to £125,000 in 2018-19, up to £150,000 in 2019-20, and up to £175,000 in 2020-21. This is in addition to the inheritance tax nil-rate band, which is set at £325,000 for the estates of individuals. This creates an effective £500,000 inheritance tax threshold for estates in 2020-21. As with the current nil-rate band, any unused main residence nil-rate band will be transferred to a surviving spouse or civil partner and means the effective inheritance tax threshold will rise to £1 million in 2020-21 for estates that can claim the full allowances.

The new main residence nil rate band will also be available when a person downsizes or ceases to own a home on or after 8th July 2015 and assets of an equivalent value, up to £175,000 in 2020-21, are passed on death to direct descendants. For example, an individual might choose to downsize from a home worth £200,000 to a home worth £100,000. They could still benefit from the maximum allowance of £175,000 in 2020-21 if they leave the home and £75,000 of other assets to direct descendants. They will only be liable to inheritance tax if the total estate exceeds £500,000.

To ensure that the wealthiest estates continue to make a greater contribution to inheritance tax receipts, there will be a tapered withdrawal of the main residence nil-rate band for estates with a net value of more than £2 million.

If, however, we look at all of this in more detail we have to question what has the Chancellor in fact achieved/done?

As well as the above announcements he also confirmed that the £325k nil rate band will be frozen until 2021 (meaning that it will have been at this level for 12 years from 2009).

The main question I have has to be why is the rise in the IHT allowance limited to a "family house" and not any other assets? There is also the fact that the allowance is only available to children or grandchildren ("direct descendants") and is not available to individuals without children. Isn't this simply making IHT more complicated? In addition why do these individuals not have the same right to leave their assets potentially IHT tax free as those with children? Finally for these individuals it can be argued that the freezing of the £325k allowance until 2021 is in fact detrimental?

Of course with the correct professional financial advice these individuals can potentially leave large estates IHT free………

Changes to Dividend Taxation:

When looking at the detail here I have to ask, why not just tax dividends as income at the same rate as other income and keep it simple with a tax-free dividend allowance set at a higher rate than £5k to compensate?

Instead, although the Chancellor presented his overhaul of the taxation of dividends as a tax cut, it is, in fact, one of the biggest revenue raisers in the Summer Budget as the government expects to raise £6.8bn over the next 5 years by replacing the dividend tax credit with a tax-free dividend allowance of £5,000 and higher taxes on income above that.

Currently, those receiving dividends benefit from a 10% tax credit. For basic rate taxpayers the 10% tax credit covers their 20% tax liability. (It is important to understand that the tax credit is in fact simply a notional credit - basic rate taxpayers don't pay the 10% tax and then receive a refund, they just don't pay tax it is the underlying companies that have paid corporation tax which is why there is a tax credit.)

This notional credit means the current tax rates on dividends are effectively:

- **0%** for those paying the 20% basic rate of income tax;
- **25%** of the net dividend for those paying the 40% higher rate of income tax and
- **30.6%** of the net dividend for those paying the additional 45% rate.

Under the new system that the Chancellor has announced, all those who receive dividends won't pay tax on the first £5,000. After that, they will be taxed at the following rates:

- **7.5%** for basic rate taxpayers;
- **32.5%** for higher rate taxpayers;
- **38.1%** for additional rate taxpayers.

The Chancellor confirmed that all these tax rates, both before and after the changes, relate to dividends received outside of ISAs and pensions. Dividends received in ISAs and pensions are, and will continue to be, tax-free (and currently the notional 10% tax credit on dividends is not reclaimable within ISAs or Sipps).

Another fact to consider is that dividend income can also be covered by the personal allowance. That is set to rise to £11k from April 2016 so someone who received all of their income in dividends could receive up to £16,000 tax-free (the £11k personal allowance and the £5k dividend allowance).

The Chancellor claimed that 85% of those who receive dividends would see no change or be better off, while over a million people would see their tax cut.

If we look at the detail here the Chancellor is, of course, absolutely right but we find that basic rate taxpayers will either pay the same amount of tax, currently zero, or 7.5% under the new rules so there are no “winners” in that tax bracket. For higher rate and additional rate taxpayers, it gets more complicated. For higher rate taxpayers, for example, someone earning less than £5,000 a year from dividends is an obvious winner, as they will pay no tax on that income under the new system, whereas they would have paid 25% previously. Some of those earning above this will also benefit. According to the Institute for Fiscal Studies higher rate taxpayers can receive £21,667 in dividend payments each year before they start paying more tax under the new system than under the current and for additional rate taxpayers the threshold is £25,250. Dividends above these levels will attract higher tax than at present.

It must be remembered and noted that taken as a whole, the changes to dividend taxation represents a tax hike, and investors of varying degrees of wealth, basic, higher and additional rate taxpayers, could, depending on their individual circumstances be adversely affected.

Conclusion

The advantages of professional financial advice remain as attractive and compelling, if not more so, after the Summer Budget.

As an example, with reference to the new dividend rules some simple financial planning such as perhaps married couples and civil partners spreading their taxable portfolios between them to make the most of each of their dividend allowances, personal allowances and basic rate tax bands may save tax (but it is important to remember that assets transferred into a sole name potentially become their sole property in the event of separation/divorce.)

Alternatively the use of annual ISA and Sipp allowances also becomes potentially even more attractive meaning tax due on dividends held outside these wrappers can be lowered.

Or a pension contribution of £3,600 in 2016/17 will extend the basic rate tax band from £43,000 to £46,600 (2016/17 tax year). Then, providing other taxable income and taxable dividend income total less than £46,600 in that tax year, dividend tax will be paid at 7.5% and none at 32.5%.

These are just some of the planning opportunities available but ultimately everyone’s financial position is different and this is where individual professional financial advice in itself might be said to pay dividends!

General enquiries phone number: 08000 85 85 90 email address: enquiries@lighthousegroup.plc.uk