Chequer Financial Services

CLIENT NEWSLETTER
MAY 2018

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THE DOG THAT DID NOT BARK

In early April, the investment markets were pricing in the chances of an interest rate rise in May at around 90%. Inflation was running at 2.5% and UK economic growth, while nothing sparkling, looked to be continuing along its new, post-crisis, post-referendum, modest trajectory.

By the time the Bank of England announced its interest rate decision on 10 May, the 90% were expecting no change, which is what the Old Lady of Threadneedle Street duly delivered.

The markets' *volte face* reflected a miserable flow of news from mid-April onwards. The Office for National Statistics' announcement towards the end of the month that it estimated the economy grew by only 0.1% in the first quarter came as a shock to all. Survey data suggested that Q2 had not started with much of a bounce back, adding to the gloom. Finally, the Governor of the Bank of England, Mark Carney, resurrected his "unreliable boyfriend" credentials. Having earlier hinted at a rate rise in Spring, he lowered already dimming expectations by saying there were other months than May when rates could be increased.

Despite its May interest rate caution, the Bank views the Q1 slowdown as primarily due to the bad (meteorological) weather – the "beast from the east" – not a deteriorating economic climate. It is thus still anticipating that rate rises will be necessary, but that "any future increases in Bank Rate are likely to be at a gradual pace and to a limited extent". Such a forecast means that the Bank does not put itself under pressure to raise rates and moves the markets focus on to August, when the Bank's next Quarterly Inflation Report is published.

ACTION

The no change decision on interest rates looks to be little more than a deferral in the face of a harsh winter. Rates will increase – as they are doing in the USA – and you should prepare for the consequences.

Rising rates can have many effects, from boosting returns on some investments to slowing down property markets. For a discussion on how your investments and financial planning might be affected, please give us a call.

A MISSED INHERITANCE TAX SAVING?

The residence nil rate band (RNRB) was introduced in April 2017 following a 2015 election pledge by the Conservatives to raise the effective inheritance tax threshold for married couples and civil partners to £1,000,000. As is often the case when manifesto promises are

translated into legislative actions, the reality proved not to be as simple as the pre-election politics suggested.

RNRB's basic features

The RNRB:

- Is only applicable to transfers of residential property on death, subject to complex rules covering downsizing or moving into care.
- Applies only to transfers made to "lineal descendants" of the deceased or the descendant's spouse/civil partner. The definition includes adopted, fostered and step children.
- Like the ordinary nil rate band (NRB), is effectively transferable to a surviving spouse or civil partner, regardless of when the first death occurred.
- Unlike the NRB, is subject to a £1 for £2 taper on estates worth more than £2,000,000.
- Is currently a maximum of £125,000, increasing by £25,000 in each of the next two tax years, so that it reaches £175,000 in 2020/21 (matching the expected timing of the next election when the 2015 manifesto was issued).

So far, so little

In the first nine months of its existence to December 2017, just over 3,000 claims for the RNRB were made in IHT returns, according to HMRC data obtained as a response to a Freedom of Information Request. It is hard to tell whether this is due to a low take up or the time delay between the date of death and the filing of the hefty volume of paperwork that many IHT returns represent: probably the majority of the returns received would have related to deaths occurring before the RNRB came into force on 6 April 2017.

What is more certain is that the complexity of the RNRB rules make it more likely that individuals completing IHT returns without professional advice risk missing or making the wrong claim.

Next steps

Earlier this year the Chancellor asked the Office of Tax Simplification (OTS) to explore simplification of the legal and administrative framework surrounding IHT. The OTS specifically mentioned the RNRB under the heading "Other Areas of Complexity" in its call for evidence. It could hardly have avoided doing so, given the withering criticism which the original RNRB legislation received from the head of the Treasury Select Committee.

Whether any reform will happen is a moot point. IHT produced a record £5,215m for the Exchequer in 2017/18, nearly 120% more than was raised in 2009/10, the last year that saw an increase in the NRB. Scrapping the RNRB and making a corresponding increase to the NRB looks an easy solution, but it would reduce the Treasury's income. From the government's viewpoint IHT is an efficient tax – it raises large sums from the estates of wealthy taxpayers who, by definition, have been removed from the electoral roll.

ACTION

The arrival of the RNRB should have prompted a review of your estate planning, unless you have no lineal descendants to whom property could be transferred. Ignoring the impact of the RNRB could add £100,000 to the IHT bill for a couple's estate in 2018/19, rising to £140,000 in 2020/21.

Call us today to arrange for an estate planning review. While the OTS review may mean changes to the RNRB in the future, reform is not guaranteed and you need to have your planning aligned to the law as it now exists – in all its complexity.

STUDENT DEBT INCREASES

Last year's general election saw the issue of student loans come to the fore, with the Labour Party saying in its manifesto that it would reintroduce maintenance grants and abolish tuition fees. The estimated cost was £11.2bn a year – by far the most expensive single proposal in the Party's manifesto. There were also hints – not in the manifesto – that all student debt would be written off, at a theoretical cost of up to £100bn according to the Institute for Fiscal Studies (IFS).

The political response

The Westminster government, which only controls student funding in England, has since reacted to Labour's proposals in two main ways:

- It has frozen the tuition fee cap in England at £9,250 for the coming academic year; and
- From April 2018 it raised the income threshold at which loans start to be repaid in England from a previously frozen £21,000 to £25,000, to be index-linked subsequently.

There were no changes made to the minimum and maximum rates of interest levied on loans, which are RPI and RPI + 3% respectively. At present that means a top interest rate of 6.1%, but from September 2018 the ceiling will rise to 6.3%. The highest rate applies during the study period and if income exceeds £45,000 after the end of the course.

Small savings, large costs…

The change in the loan repayment threshold will initially save graduates up to £360 a year, as the current repayment basis is 9% of all income above the threshold. The inevitable corollary – even before the interest rate rise is considered – is that debt will linger longer. More graduates will therefore reach the magical point, 30 years after graduation, when their outstanding debt is written off.

The IFS has calculated that the change to the threshold and the tuition fee freeze will ultimately mean that 45% of all student debt is repaid by the government. In the long run, the IFS says the changes will add £2.3bn a year to taxpayer costs for higher education.

Lessons to learn

As the cost of the Labour Party's proposals shows, there is no cheap way to deal with the issue of student finance going forward, yet alone addressing the debt accumulated to date. One of the more ironic side effects of any reduction in payments or greater write downs is that it tends to be the higher earning graduates who gain most, as they are the most likely to have paid off their debt within the 30 years from graduation.

If you have children or grandchildren heading to university, setting aside some money for them makes sense. However, that is not the same as saying they should refuse the loans on offer, as all or part of them may be written off eventually. Where the extra funds count is *after* the course has ended. At that stage a typical graduate earning above the loan repayment threshold will probably be facing the loss of at least 45p of every extra pound earned, thanks to income tax (at least 20%), national insurance (up to 12%), auto-enrolled pension contributions (up to 4% net) and student loan repayments (9%).

ACTION

The student loan system is best thought of these days as a graduate tax, because its effects are driven by income earned and is only felt once tuition is over. It is then that financial support can be the most valuable, be it in reducing the debt or helping in the purchase of a first home.

Ask us about the options for providing funds for future graduates and more information on the student financing rules (which vary in all four parts of the UK).

THE GROWING PENSIONS TAX BILL

Pensions are generally thought of as a highly tax-efficient way of saving, but this is not true in all circumstances. There are two features built into the original "simplified" pension tax regime which, after a series of detrimental changes, could now start to make a pension tax *in*efficient for you:

The lifetime allowance

The lifetime allowance (LTA) effectively sets a maximum tax-efficient ceiling on the total value of benefits that can be provided by your pension arrangements. It began life at £1.5m in 2006/07, rose to £1.8m by 2010 and then from 2012 was cut three times, reaching £1m in 2016. In April of this year there was a small, inflation-linked increase, taking the LTA to £1.03m.

The various cuts were accompanied by transitional reliefs but, until the last set emerged a couple of years ago, these had to be claimed within a relatively short period after the

change. Whereas once the LTA was seen a means of discouraging the accumulation of excessively large pension funds, there is growing evidence that it is now a new source of tax revenue for the government. Funds above the LTA can attract a lifetime allowance charge at up to 55%.

Information obtained under a Freedom of Information Request revealed that between 2014/15 and 2016/17 the number of individuals caught by the LTA charge increased by over 135%. The tax raised over the same period almost trebled to £110m.

The annual allowance

The annual allowance (AA) is the twin sister of the LTA and effectively sets a maximum tax-efficient ceiling on the total contributions that can be made to your pension arrangements in a single tax year, albeit with some limited carry forward provisions. The latter were not needed when the AA came into being with a limit of £200,000, rising to £255,000 by 2010/11. In April 2011, the AA was slashed to £50,000 and three years later further reduced to its current level of £40,000.

High earners then became subject to complex AA tapering rules in 2015/16, which could cut their AA to as little as £10,000.

Another reduction, more limited in scope, saw the introduction in 2015/16 of the money purchase annual allowance (MPAA) at £10,000, which applied once flexible income started to be drawn. Two years later the MPAA was cut to £4,000.

Contributions above the available AA/MPAA, regardless of source, are subject to an annual allowance charge. This operates by taxing the contributions as the member's income, thereby effectively removing all personal tax relief.

Watch out

It is not always obvious that the allowances have been or will be exceeded, particularly if a defined benefit pension scheme is involved. The tapered AA is a cause of many problems, as the taper is based on full tax year income data which means its exact impact is only known in retrospect.

If you have any of the transitional LTA protections, care needs to be taken to ensure these are not lost, which is not always straightforward. The tax savings these provisions offer can now stretch to the hundreds of thousands of pounds.

ACTION

If you are or think you could potentially be affected by the LTA or AA, planning and regular reviews are essential. In some cases you may need to revise your retirement strategy, considering alternative ways of building up sufficient capital for when work ends.

Tax penalties, like the LTA and AA charges, are best avoided, although with this duo it is not always possible to do so. The sooner you plan for their potential impact, the easier it is to limit their worst effects.

COMPANY CARS: BEWARE THE RULE CHANGE

If your company car is due for a change this year or next and you can choose a mix of cash and/or car, be warned. There has been a change in the tax rules on optional remuneration arrangements (OpRA in the jargon) which may colour your choice of car or even whether to opt for cash.

The old rules

Before 6 April 2017, provided the salary sacrifice scheme had been set up correctly, if you gave up some of your earnings in exchange for a company car, what you were taxed on was the benefit value of the company car, regardless of whether it was more or less than the salary foregone. For example, in March 2017 you might have had the choice of £5,000 a year salary or a BMW 320i costing £33,000. The benefit value of the BMW in 2016/17 was £7,590 and in the current tax year is £8,910. What you would pay tax on in each year is that benefit value, not the £5,000 pay you gave up (which would roughly have matched the annual cost of a three year lease).

Any sacrifice arrangement in place before the start of 2017/18 remains on this basis until 6 April 2021 unless, unusually, the car had CO_2 emissions of not more than 75g/km. However, any replacement car falls under the new rules.

The new rules

The new rules took effect from the start of the last tax year and say you must pay tax on *the greater of* the salary foregone and the benefit value of the car. As the previous example suggests, the typical car benefit value will exceed the salary foregone. However, that will not always be the case, despite the government's annual increases to the taxable benefit scales.

ACTION

The new rules highlight a point often overlooked: your company car could be considerably more taxing than the cash alternative. What was once a sensible benefit-in-kind may no longer be so. ***While the salary sacrifice rules have been toughened for cars, there has been no change in the treatment of salary sacrifice for pension contributions. This still has major tax advantages which we would be happy to explain.***

Past performance is not a reliable guide to the future. The value of investments and the income from them can go down as well as up. The value of tax reliefs depend upon individual circumstances and tax rules may change. The FCA does not regulate tax advice. This newsletter is provided strictly for general consideration only and is based on our understanding of law and HM Revenue & Customs practice as at May 2018. No action must be taken or refrained from based on its contents alone. Accordingly no responsibility can be assumed for any loss occasioned in connection with the content hereof and any such action or inaction. Professional advice is necessary for every case.