

# Osborne administers the fiscal medicine



## Saunderson House reflects on the potential impact on retired partners of George Osborne's Emergency Budget

**The recent Emergency Budget was described by the Chancellor as “tough but fair” and “necessary to rebuild the economy following irresponsible management by the previous administration” But how tough and fair will it be for you?**

Despite the lack of any real debate during the election campaign, the scale of spending cuts and tax increases needed to put the government's finances back on an even keel was widely appreciated long before George Osborne stood up on 22 June to deliver his Emergency Budget. The new Chancellor duly administered the £40 billion fiscal tightening required, with reduced spending accounting for 80% of the consolidation and tax rises the remaining 20%. On taxation, the increase in VAT to 20%, with effect from January 2011, is by far the most important measure,

raising approximately £12 billion in fiscal year 2011/12. On the spending side, much of the detail will not be revealed until the Spending Review is published in October. However, it is implicit from the arithmetic that massive cuts (outside the protected areas of health and overseas aid) of around 25% of departmental budgets over the lifetime of the parliament will be required.

On balance, investors were heartened by the budget. Gilt prices rose and any residual risk to the UK's AAA credit rating was, effectively, extinguished. In response to the budget measures, the newly established Office of Budget Responsibility marginally reduced its forecasts for economic growth for the next two years, but increased those for 2013 and 2014. However, fiscal tightening on this scale is unprecedented and it remains to be seen whether the

fragile economic recovery now taking place in the UK can be maintained despite the new fiscal austerity.

### **Taxes**

Overall you will probably pay more; taxes are going up. However, there are a number of measures individuals can take to reduce the impact.

Much of the press speculation prior to the Budget surrounded the potential equalisation of the capital gains tax (CGT) and income tax rates and the potential reduction or removal of the annual CGT exemption. Effective from 23 June 2010, capital gains tax rose from 18% to 28% for those with total income and taxable gains above the higher rate income tax threshold. Basic rate taxpayers will continue to pay an 18% rate on their gains. Those with taxable gains that take them into the

higher rate bracket will pay tax at 18% and 28%, as appropriate. Taper relief or indexation was not be reintroduced, however the increase in the rate of CGT was less than feared and the CGT annual exemption remains at £10,100 for 2010/11 and will rise in line with inflation going forward.

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Given the continued disparity between the rate of income tax (50%) and the rate of CGT (28%) for additional rate tax payers (specifically those with incomes above £150,000), there remain benefits in holding assets that produce the majority of their returns in the form of capital gains as opposed to income, such as equities, directly. Furthermore, the continuation of the annual CGT exemption means that gains on modest portfolios can potentially be managed without liability to CGT.

For the 2010/11 tax year, individuals who have gains which would otherwise be charged at different rates, as they fall either side of 23 June, will be able to utilise both losses and the CGT annual exemption in a way which minimises the tax due.

The 10% CGT rate for entrepreneurial business activities will be extended from the first £2 million to the first £5 million of qualifying gains made over a lifetime.

Income tax rates and bands previously confirmed in the 2010/11 tax year remain unchanged. In particular, individuals will continue to be taxed at 50% (42.5% for dividend income) on income received over £150,000, while the personal allowance will be removed at a rate of £1 for every £2 of income earned over £100,000. This causes an effective income tax rate of up to 60% on income earned between £100,000 and £112,950. Those who are able to regulate their income, for example by varying the level of income paid by an unsecured pension (income drawdown) plan, transferring assets to a spouse or potentially

sheltering income for example through a single premium investment bond, should monitor the tax bands carefully.

Going forward, the Emergency Budget announced that the personal allowance for under-65s will be increased by £1,000 to £7,475 in 2011/12, as part of a long term objective to raise the personal allowance to £10,000. However, this will not benefit higher rate tax payers, since the higher rate tax threshold will be reduced accordingly.

There was no proposed change to the current plan to increase the rates of National Insurance by 1% from 2011/12 (with the exception of the 0% bands).

Putting all of the above into context, a self-employed partner with gross annual income of £500,000, would have received/will receive, net of income tax and National Insurance, the following income:

2009/10	2010/11	2011/12
£302,331	£264,741	£259,598

However a retired partner, who is no longer paying National Insurance contributions and who successfully caps their income at £100,000 pa, will receive the same net income.

Finally, the new government has confirmed that the nil rate band for inheritance tax will remain at £325,000 until the end of the 2014/15 tax year.

**Pensions and Tax Efficient Savings**

The government plans to end the ‘effective obligation’ to purchase an annuity (or to advance into alternatively secured pension) by age 75 from April 2011 and will consult on this later this year. Transitional measures are being introduced for individuals who will reach age 75 before April 2011. Specifically, the 2010 Finance Bill will increase the age by which one needs to purchase an annuity to 77 (for those who had not reached age 75 by 22 June 2010), thus affording those approaching age 75 time to wait for the conclusion of the consultation.

Under the transitional measures, it will still be necessary for individuals to vest (take benefits from) their pensions prior to age 75. This means that the entitlement to pension commencement lump sum (PCLS, the new name for tax free cash) will end at age 75; however,

it will be possible to remain in unsecured pension (USP) until age 77. Scheme members who chose to defer securing their pensions beyond age 75, under the transitional measures, will be subject to the same income rules and death benefits as applied before they reached age 75.

We await the conclusions of the consultation, however it appears that improved heritability will be a feature of pensions going forward.

The government has also said that introducing a taper for the removal of higher rate pension tax relief would introduce unnecessary further complexity, following ‘pension simplification’. They currently favour simply reducing the annual allowance to c£30,000 to £45,000. For those with earned income, this implies that tax relief of 50% on contributions for high earners would still be available from 2011/12 onwards. Some insurance companies have suggested that this may also coincide with changes to, or the potential removal of, the Lifetime Allowance (LA). The relaxation of these rules will be welcome for those who can still contribute from earned income.

As announced in March, from 2011/12 ISA allowances will rise in line with RPI. The £10,200 ISA annual allowance remains a valuable tool with which to build a tax free capital sum.

Clearly the interaction of each of the factors is complex and dynamic. However, if managed correctly, we believe significant tax savings can be achieved without impacting negatively on investment performance.

**Contact details:**

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Tony Scott-Clarke, Director  
on 020 7315 6638

Gareth Parsons, Chartered Financial Planner  
on 020 7315 6521

Christopher Sexton, Investment Director  
on 020 7315 6506

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