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Provident Money

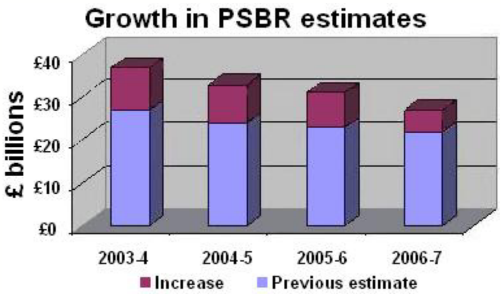
Your independent window on financial issues **Spring 2004**

Budget promises increased spending

Nothing in the budget surprised anyone very much, but then nobody expected to be surprised.

The key feature of the budget was an increase in many areas of government spending with no accompanying rise in direct taxation. This does, however, mean an increase in government borrowing and an extra £10 billion is required for this year, with a further £23 billion above previous forecasts over the next three financial years.

Does this matter? Well its rather like a family increasing its borrowings while times are good; repayments are affordable and life is comfortable. However, the problems can start should your income fall, for reasons beyond your control, or the loans actually have to be repaid. If you don't have reserves to cover your liabilities, you may have difficulty in paying off your borrowings. And the same can happen to a country that borrows now, on the basis of future (continued) prosperity.



The only alternative, should economic circumstances fail to stay in line with the Chancellors forecast of 3% - 3½% economic growth for next year and 3½ % - 3% for 2005/6, is substantial increases in taxation.

He promised to reduce Civil Service numbers by 40,000—some of which have already been announced. This will come as welcome news to those who had noticed a half million rise in the number of public sector jobs, during the last seven years.

What is, perhaps, most important is what was ***not*** said. While the delay in pension reform will probably be welcomed by insurance companies and many employers, as this will at least give them time to get ready.

However, there was additional encouragement for investors in Venture Capital Trusts (VCTs) with tax relief being available at the higher rate of 40%, for the next two years, on investments up to £200,000.

Chancellor Gordon Brown's eighth budget speech held few surprises

Recent figures show that the savings ratio—that is the proportion of income invested by the average family—has fallen from 10% in 1997 to 5% in 2003. And this includes pension provision.

Yet the capacity of the state to provide adequate retirement benefits for an increasingly ageing population is severely constrained, making personal provision essential.

It is therefore unfortunate that the opportunity has been missed to reverse the removal of tax reclaim on UK dividend income on ISAs and pension funds and to limit, in two years' time, the amount that can be invested in a Cash ISA.

The main tax thresholds have been increased broadly in line with inflation, including the level at which Inheritance Tax applies, which is rapidly converging with average house prices. Details of the main changes appear on the back page.

University fees—the tip of the iceberg?

With Universities expected to be able to charge fees of up to £3,000 from 2006, many young people could be facing a debt of more than £20,000, by the time they start work.

For those parents who have been paying school fees, this might even come as a relief, since some will already be forking out something approaching this amount annually.

But for most families, this is likely to be a significant factor in deciding whether or not a university education is the right way forward. What's more, it is most unlikely that the amount the student can borrow will be enough to cover the fees and living expenses. The Institute of Fiscal Studies has estimated that a family with an income of just £44,000 a year, will have to find £11,000, over three years—more than £3,600 a year—to cover the difference between the cost of educating a student at university and the loans available. A family on less than £35,000 a year will have to find more than £8,000 over the period.

Clearly, this is likely to be a significant commitment and advanced planning can significantly reduce the impact, when the time comes. If parents can start planning for education costs at birth, then it is possible to put together a strategy that can cover school fees as well as university costs. But for most families, private education is not a practical option and thinking about university costs is actually far more important, because the child will be away from home for the first time—and with little experience of making ends meet!

The overall cost of University education is rising

For the next two tax years, it will still be possible to invest up to £7,000 each into an ISA; from April 2006, this will fall to £5,000 per person. In practice, this is probably not a major problem for most families, for whom the reduced limit—especially when applied to two parents—will be all they can manage. More worryingly, the amount that can be invested into cash is falling from £3,000 a year to £1,000, at the same time. This could impact on those who have only a short time to go before at least some of the money is required since, although interest rates are hardly attractive at the moment, equities are seldom considered suitable for the short term.

For this reason, it is a good idea to start planning as soon as possible, matching the asset allocation to the timeframe within which an income will be required. If there are more than ten years to go before money is required, then an equity based strategy, perhaps with some form of deposits to provide short term liquidity, could be appropriate. But those with only a short time to go might wish to consider a more cash based strategy, in which case early action should be considered.

It is also worth considering that all bread winners should review the level of their life assurance and income protection plans, since grants and fees will be based on income in the previous year. So if the main earner should die—or become ill for a sustained period—there might not only be an immediate income shortfall, but this could also affect the following year.

Key points:

- Grants and loans will not cover the costs for any student
- Planning early is essential—the sooner the better.
- The longer you have, the more flexible your investment strategy can be
- Considering life assurance and income protection is also worth considering.

Inheritance tax

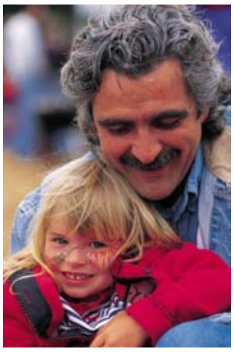
It is sometimes said that Inheritance tax is a voluntary duty, paid only by those who trust their children even less than they dislike the taxman. This may seem a little harsh, but there is a kernel of truth, in that careful planning can mitigate the impact significantly, even if not eliminating it altogether.

Most people will be aware that Inheritance tax (IHT) is levied on the value of an estate passing on death to anyone other than a surviving spouse – this could soon be extended to partners in suitably registered same-sex relationships. But the principal remains the same; anything over £255,000 (£263,000 from 6th April 2004) is liable to tax at 40p in the £.

Due to rapidly rising house prices, over the last few years, few families can escape the impact of this completely, however distressing a time it might be, the taxman has to be paid within a very short space of time.

There are ways of reducing your liability to IHT, however.

Firstly, each person can give away money during their lifetime without creating a tax liability. This is normally £3,000 a year (per donor) although additional small gifts of £250 per recipient are allowed. What's more, anyone can give their son or daughter £5,000 on marriage, so in the year that their daughter marries, a mother and father together could effectively give her £16,000 between them, provided they give no other gifts to other people. In addition, the grandparents could each give an additional £2,500 per surviving grandparent.



Passing money directly to grandchildren can have appeal

More importantly, anyone can give gifts from income without generating a potential IHT liability, provided that the amount does not reduce their standard of living.

All other gifts are known as potentially exempt transfers (PETs). That is, if the donor survives for at least seven years after making the gift, its value is disregarded when looking at the estate on eventual death. If the donor dies within the seven years, then IHT is potentially incurred on a sliding scale.

Where planning can be undertaken early, using whole of life policies, written under Trust for the benefit of children and grandchildren, can be valuable, since the premiums can be kept below the £3,000 a year threshold – or at least within the bounds of 'normal income expenditure' so that the monies within the Trust are completely separate from the estate and thus free of IHT, on death. This money may not deplete the estate sufficiently to eliminate the IHT liability entirely, but the proceeds can be used to pay off part or all of the tax liability, thus holding the balance of the estate intact and avoiding the need for the 'distress sale' of a family home.

However, more sophisticated IHT planning is available, including transferring the family home into a Trust, while allowing the parents to continue using it. There are pitfalls to this option and it is essential to take professional advice before making any decisions.

Another option is to use an equity release scheme to reduce the value of the home by selling part of it to an insurance company and then using the cash generated to produce an income. This reduces the value of the estate on death, but leaves the individual with a secure home. Monies released can be used to help family members with expenses or simply to secure a more comfortable retirement.

At the very least, married couples should consider passing across some of their estate to the next generation when the first of them dies, as up to £263,000 (from 6th April) can be handed on without creating an IHT liability, whereas passing the entire estate to the surviving spouse simply increases the amount exposed to taxation, on the second death.

Key points:

- Many families are now affected, due to rising property prices.
- Tax applies at 40% above the threshold.
- Small gifts can be given each year.
- Larger gifts require the donor to live seven years.
- Trusts can be used to reduce the impact.

Managing borrowings

According to statistics from The Mortgage Lender, the average man in the UK owes £3,741 and the average woman, £2,880. In both cases, that represents more than seven weeks average earnings. So someone on the national average income will work through the whole of January and half of February, before they have earned enough to pay off their short term borrowings. And that does not allow for tax and National Insurance deductions.

Yet at the same time we all constantly receive offers of new credit cards and low cost loans, both on television and by direct mail. Some of these deals can look very attractive, especially those encouraging us to transfer balances from one card to another – until, that is, you realise that some of the terms are not quite as good as they look. For example, nil interest on transfer balances might be fine, unless you actually use the card to purchase anything new, in which case you will usually find that the old "free" credit is paid off first, so that you incur the full interest rate on all new purchases.

Of course, while we are earning, this need not be too much of a problem. But there is a cloud on the horizon – the spectre of rising interest rates. We have recently seen two modest hikes in base rate, and many commentators suggest that there will be more to come. This will not only affect short term borrowings, but also mortgages. So those with large mortgages could feel the pinch very quickly and find that the 'extra' borrowings on credit cards and personal loans are not just more expensive, but have to be paid from less disposable income, as mortgage costs rise.

Borrowing money can be all too easy

One option is, of course, to consolidate all your loans into your mortgage. However, this is not always as straightforward as it might appear and it is important to ensure that you do not incur extra charges that might mitigate any benefit. Another option for debt management is to consider an offset mortgage, many of which now allow you to offset your savings against credit cards and other personal borrowing as well as a mortgage. A good scheme will even offset against the debt that carries the highest interest rate first. Even if you don't have much in the way of savings, just having your salary paid into the account can save you interest, as there is a delay before spending depletes your account again.

It is, of course, essential to ensure that you have adequate life assurance and income protection insurance to protect your family, in case of unforeseen events. After all you don't want to saddle your family with debt if you die – or, indeed, yourself should you become incapacitated or unemployed.

It can be helpful to check your credit rating, to see just how you stand. This can be done on-line from companies such as Experian Limited at www.experian.co.uk which offers a simple to use on-line or postal service. This will tell you if your credit history is impaired, which could be helpful when talking to anyone about rescheduling borrowings.

It is also worth knowing that the government has recently issued a White Paper on Consumer Credit, aimed at reducing the number of 'loan sharks' about, as well as reinforcing regulation of lenders and ensuring consumers have better information. In particular, greater fairness for those repaying early is envisaged.

Key points:

- Borrowing in the UK is equal to seven weeks' average earnings.
- Some offers of credit are less generous than they may at first appear.
- Offset mortgages can help manage debt.
- Adequate family protection is essential.
- A credit check can be worth the modest fee.

Budget summary

The main tax levels will be as follows from 6th April 2004, subject to the Finance Bill being passed.

Income tax:

Rate		2004/5 Income band	2003/4 Income band
Starting	10%	**Up to £2,020**	*Up to £1,960*
Basic	22%	**£2,021 to £31,400**	*£1,961 to £30,500*
Higher	40%	**Over £31,400**	*Over £30,500*

Capital gains tax:

	2004/5	2003/4	Change
Tax rate (individuals)	Top slice of income tax		
Exemption			
Individuals	**£8,200**	*£7,900*	£300
Trusts	**£4,100**	*£3,950*	£150

Inheritance tax:

	2004/5	2003/4	Change
Tax rate (individuals)	**40%**	*40%*	
Threshold	**£263,000**	*£255,000*	£8,000

Income tax allowances:

	2004/5	2003/4	Change
Personal allowances:			
Up to age 65	**£4,745**	*£4,615*	£130
Ages 65 to 74	**£6,830**	*£6,610*	£220
Aged 75 and over	**£6,950**	*£6,720*	£230
Income limit for age allowances	**£18,900**	*£18,300*	£600
Married couples allowance			
Aged under 75 (born before 6/4/35)	**£5,725**	*£5,565*	£160
Aged 75 and over	**£5,795**	*£5,636*	£160
Minimum amount	**£2,210**	*£2,150*	£60
Blind person's allowance	**£1,560**	*£1,510*	£50

National Insurance:

Lower earnings limit rises to £79 per week (from £77)

Upper earnings limit rises to £310 per week (from £595)

Threshold (primary and secondary) £91 per week (from £89)

Back page briefing

For some people, retirement seems a long way off. Yet the later we leave it before starting to plan, the more difficult it becomes to achieve our goals—even if these are quite modest. The danger is that warnings of dire consequences if certain action isn't taken might be taken with a pinch of salt. And in most cases, this is right.

It is therefore with diffidence that we say: "act now on retirement planning before its too late." We fully recognise that few people in the UK do not have at least some retirement plan, even if it is only the state pension.

But as everyone knows, the state pension is unlikely to be of much value to anyone on its own, so individual planning is essential, as well. However, our planning can take into account that there is some form of underpin.

With this in mind, we looked at the cost of providing an income in retirement with a purchasing power of just £15,000 a year, in today's terms.

For a man of 35, with 30 years to go to state retirement age, putting aside just £465 a month should (assuming inflation in line with the RPI, fund growth of 7% a year and charges of 1% a year) provide a pension that has a purchasing power equal to £15,000 a year, today. And provided he is earning about £32,000 a year, this is within the current limit he can spend.

But look forward just ten years, and the amount he would have to save rises to £777 a month; that's 67% more. What's more, with the current contribution limits, he will have to be earning at least £46,600 a year to permit such high contributions. And if he waits a further five years, the contributions rise to more than a thousand pounds a month – almost 40% more again, with an earnings requirement of £52,000 a year.

One of these problems—the amount you need to earn, in order to support large pension contributions—is due to be relieved in April 2005, with anyone being able to contribute up to their entire earnings (subject to an overall limit of £200,000 a year). But in practice, this is unlikely to help most people, who have to live out of their income, as well as save for retirement.

Saving for retirement is becoming increasingly important, as the real value of state pensions is expected to fall over the next few decades, due to a fall in the support ratio (that is the number of working people to pensioners and other dependents).

Starting to make additional provision as soon as possible is essential. But, of course, there are a number of ways in which this can be achieved and it is important to seek independent financial advice before making investment decisions.