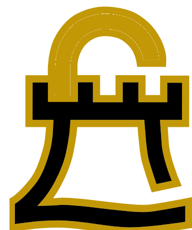
financial focus

Autumn 2009



BLACKTOWER FINANCIAL MANAGEMENT LIMITED
WEALTH MANAGEMENT ADVISERS
CHARTERED FINANCIAL PLANNERS

IHT demise exaggerated

A couple of years ago, inheritance tax (IHT) grabbed the headlines, with one national newspaper running a high profile campaign for its abolition. But, once Alistair Darling had announced in the 2007 Pre-Budget Report that the nil-rate band (currently £325,000) would be transferable between married couples and civil partners, IHT began to fade from view.

The credit crunch combination of falling house prices and declining share values further reduced IHT's prominence, because both factors reduced estate values.

You might think that IHT is no longer an issue, except for multi-millionaires, but you would be wrong:

- If you are married or in a civil partnership and your total joint estate (including your home) is worth more than £650,000, then your beneficiaries could still see the Exchequer take a slice of their inheritance. For instance, on a joint estate of £1 million, the IHT bill is potentially £140,000.
- If you are unmarried, then IHT can be a more serious problem. On death, spouses and civil partners can generally make gifts to each other free of IHT and transfer any unused nil-rate band to the survivor, but neither opportunity applies to unmarried couples. As a single person, IHT becomes relevant if your estate is worth more than £325,000.
- The complexities of IHT mean that you (or your executors) could face a tax bill because some aspect of your financial planning had been overtaken by legislative or other changes. One of the more obvious examples is an out-dated will – and that could now mean a will drawn up only a few years ago. (If you do not have a will, the rules of intestacy can easily create an unnecessary IHT liability, along with other unwelcome complications. So it may be wise to draw up a will.)

Although IHT rules have been strengthened over the years, there is still a variety of schemes that may help limit the impact of the tax on your beneficiaries. A few of these arrangements have been in existence for many years and their effectiveness has been accepted by HM Revenue & Customs. However, IHT schemes can only go so far. If you are concerned about IHT, there is no real substitute for a thorough review of your financial planning with a close focus on its overall IHT effectiveness. Sometimes relatively minor changes can make a significant difference to the overall IHT liability.

Levels and bases of, and reliefs from, taxation are subject to change and their value depends on the individual circumstances of the investor. The FSA does not regulate taxation, will writing, and some forms of estate planning.

In this issue: Building on financial foundations • Higher rate pension relief hits trouble • The rising costs of education • Planning for complicated lives • Escape your bonds • It'll never happen?

This newsletter is for general information only and is not intended to be advice to any specific person. You are recommended to seek competent professional advice before taking or refraining from taking any action on the basis of the contents of this publication. The newsletter represents our understanding of law and HM Revenue & Customs practice as at August 2009.

Building on financial foundations

A grandparent could spread any amounts they were prepared to invest between the CTF and a personal pension arrangement to achieve what they would like for their grandchild or grandchildren.

There are now two really tax efficient ways to give grandchildren – or even people who are not related to you – a valuable nest-egg for the future.

The child trust fund (CTF) was introduced with effect from 6 April 2005 and every child born on or after 1 September 2002 benefits. The government pays £250 at birth for each child in the form of a special voucher and then again when the child reaches the age of seven. The parents or guardians have to choose the CTF product to hold the money. If the voucher is not invested within a year, HM Revenue & Customs will open a stakeholder account on behalf of the child. The government is considering a further payment for children when they are 11, although this initiative might not survive the next election.

The tax treatment of the CTF is very like an ISA. Any growth on the fund is tax free (apart from non-reclaimable tax credits on dividends), and there is no tax on any profit when the child becomes entitled to the fund at age 18. The growth in the fund does not have to be reported to the tax authorities on a tax return – making the whole process very simple.

Grandparents (or anyone else) can also contribute to a CTF where the funds will benefit from these tax privileges. The maximum contributions are £1,200 a year to each CTF. For this purpose each year runs from the date of the child's birthday. So each year, a grandparent could give up to £1,200, or the allowance could be shared with someone else.

When the grandchild becomes 18 he or she may well be able to find a good use for the cash. For example, the CTF could be used to cover a substantial part of the costs of going on to higher education. Alternatively, the tax-free fund could be used to finance the deposit on a house, or even to help start a business.

Personal pension arrangements

But there is also a highly tax efficient way for grandparents, or other family or friends, to help build up funds for the long term. That is to invest in a personal pension arrangement for the child. The fact that the child will not be able to access the benefits until they reach the age of 55 might seem like a major drawback when compared with the CTF or other gift programmes. But it is because of the length of time that the funds are invested, combined with the tax privileges given to pensions, that the long-term benefits are likely to be so valuable.

Uplift and growth

The great advantage of making a pension contribution is the tax position. There is tax relief on the input so that the grandparents can pay up to £2,880 into the plan, but the government then tops it up to £3,600 with £720 of tax relief. That is an immediate uplift of a quarter of the net contribution.

The funds then grow in a fund that is largely tax free – apart from the non-reclaimable tax credits on dividends. When the beneficiary wants to draw on the funds – after the age of 55 years – up to a quarter of the fund will be free of personal tax and the rest must be used to provide a taxable lifetime income, which is generally paid as an annuity.

Remember the old adage that the sooner you start contributing to your pension, the greater the potential benefits. The trouble is that most people simply cannot afford to make pension contributions in their 20s, so making contributions during their childhood and even into their teens provides a wonderful financial underpinning for the rest of their lives.

A grandparent could spread any amounts they were prepared to invest between the CTF and a personal pension arrangement to achieve what they would like for their grandchild or grandchildren.

The FSA does not regulate tax advice. Past performance is not a reliable indicator of future performance. The value of investments and the income from them can go down as well as up, and you may not get back the original amount invested. Levels and bases of, and reliefs from, taxation are subject to change and their value depends on individual circumstances.

ISA top-up time

In his April Budget, the Chancellor announced an increase in the contribution limits for individual savings accounts (ISAs). The lateness of the Budget and, probably, the tightness of government finances, meant that the increase was staggered:

- From 2010/11 the maximum overall contribution will rise from £7,200 to £10,200 of which £5,100 (previously £3,600) may be invested in a cash ISA.
- If you were born before 6 April 1960, these higher limits will apply for 2009/10, but only for contributions made after 5 October 2009.

If you are 'mature' enough to benefit from October, then do ask for our advice before investing. For example, if you have already contributed to an ISA in this tax year, your options may be constrained by rules which say you can only contribute to one cash ISA and one stocks and shares ISA during the tax year.

Higher rate pension relief hits trouble

The government has reduced the tax relief on pension contributions for people with high incomes. This has implications for many people – not just the high earners directly affected.

The restrictions will apply if your total income is £150,000 in the current year or at this level in either of the two previous tax years. The new rules cover both individual and employer pension contributions into any registered pension schemes ranging from personal pensions to final salary-related schemes. The higher rate tax relief is taken away through a special tax charge on you personally. The rules were introduced in the Finance Act 2009 and will be replaced from 2011/12.

For the tax years 2009/10 and 2010/11, people with incomes of at least £150,000 can still benefit from full tax relief on limited levels of contributions. The rules are complicated. Quarterly or more frequent contributions started before 22 April 2009 are basically not affected and there is an annual allowance of at least £20,000 of contributions, which can be higher in certain circumstances. Ask us for details if you think you might be affected now or in the future.

From 2011/12, the restrictions on tax relief are due to be generally tighter. For incomes of at least £180,000, the tax relief for all pension contributions will be at basic rate only. For incomes between £150,000 and £180,000, tax relief will be tapered down from the higher rate to the basic rate. Tax relief at your highest marginal rate will still be available for all pension contributions if your income is less than £150,000.

Are pensions worth it?

The restrictions raise the question of whether it makes sense to contribute to a pension if relief is limited to basic rate relief. If you are a higher rate taxpayer in retirement, the rules mean that you would have received contribution tax relief at a lower rate than you would be paying tax on your pension. As is often the case in personal finance, matters are rather less straightforward. Among the factors that still weigh in favour of pensions are:

- Employer contributions do not suffer national insurance contributions (NICs) – this alone is a considerable advantage over drawing salary or bonus.
- Within a pension plan there is no UK tax on investment income or gains (although UK dividend tax credits cannot be reclaimed).
- On death, before any benefits are drawn, the whole fund will normally be available as a lump sum to your beneficiaries, free of UK taxes, including inheritance tax.
- As a general rule, 25% of the pension fund can be taken as a lump sum free of tax when the individual is entitled to draw income from the plan.
- Most non-pension investments do not offer any tax relief on entry. Those few that do are typically high risk, such as enterprise investment schemes.

These potential benefits mean that you should not dismiss pension contributions out of hand if your tax relief is prospectively limited to 20%. Ultimately, a decision about the relative benefits of 20% tax-relieved pension contributions will depend upon your personal circumstances and retirement planning objectives. It is also a choice that will need to be reviewed regularly as more is revealed about the second stage of the legislation. If you are below the £150,000 threshold and qualify for higher rate tax relief, it is probably a good idea to take full advantage of the situation while it still lasts.

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Did you know that if you do not file your tax return online, then normally you must file your paper tax return for 2008/09 by 31 October 2009? Miss the Halloween date and you must file via the internet, which has a cut-off date of 31 January 2010. However, given the problems there have been in the past with last-minute filing, you would be well advised to make your online return as early as possible in the new year. Filing your return on paper does not alter the tax payment due dates, which remain 31 January and 31 July. The FSA does not regulate taxation advice.

The rising costs of education

School fees increased by an average of 5.90% in 2009, according to the Independent Schools Council. Termly fees ranged from an average of £3,358 for day schools to £7,748 for boarding schools, although there was quite a range depending on the actual schools chosen.[1]

In the difficult economic climate, there is growing parental pressure on schools to keep down their costs, but this has not proved easy in the face of rising staffing costs and the demands of the Charity Commission for many schools to increase their provision of bursaries and scholarships.

One of the best ways to help families afford private education for their children is to build up funds in advance. Very few people can pre-fund the whole costs of a child's education, but even a relatively modest education fund can reduce the pain of the termly bill and tide over periods of financial hardship on redundancy or other difficulties. It is well worth parents saving, and grandparents or other relatives can be an invaluable help. Even for those where the children/grandchildren attend a state primary school there may be time to effect planning for funds to be set aside so that they can attend a private secondary school.

Tax saving is an important aspect of school fees planning. If you pay school fees from your current earnings, the money will have suffered income tax, at up to 40% (or even possibly at 50% from next April) as well as national insurance contributions.

Leaving school will not be the end of education costs if the child goes on to higher education. The costs of university fees, books, computers, travel, accommodation, food and socialising can be considerable. Some early tax and financial planning can help greatly. You may also be able to help the student avoid starting working life with the burden of a student loan.

Asset allocation

So, what types of investments could the parents and grandparents consider for funding the costs of education? The most important decision is the asset allocation. The shorter the period to paying the school fees or other costs, the less risk you can afford to take. If you start early and have, say, at least eight years or even longer before you are likely to need to draw on the funds, you can probably afford to think about investing in more volatile investments and you should consider what proportion of your funds should be invested in equity-based investments. These can go down as well up and their past performance is not a reliable guide to their future returns.

Otherwise, you could stick to cash or possibly safe, fixed-interest bonds. However, if you are prepared to accept some risk to your capital, and to investing longer term (for, say, at least five years), the returns may be much better than if you want instant access to funds. But, of course, you run the risk of making lower returns, or even a loss.

Tax wrappers

Tax efficiency is also very important. There is now a wide choice of tax wrappers and the right one will depend on your individual circumstances. Individual savings accounts (ISAs) are very attractive tax wrappers for investments – including cash and bonds. Income and growth within ISAs are tax free apart from any non-reclaimable tax credits on dividend income.

Collective investments such as unit trusts and OEICs are also tax efficient. The funds are free of capital gains tax (CGT) until they are encashed or given away, though only if the gains exceed the CGT allowance (£10,100 for the 2009/10 tax year). You can use your CGT allowances to manage or save tax as you encash them for school fees.

Life assurance based investment vehicles can also be attractive for some investors, mainly because they shelter income in a relatively low tax environment until the investment comes to be encashed. We can advise whether they would be suitable for you and your family.

This can be a complicated area where you need access to both tax and investment planning expertise.

Past performance is not a reliable guide to future performance. The value of investments and income from them can go down as well as up, and you may not get back the original amount invested. The FSA does not regulate tax advice or school fees planning.

1. Source: www.isc.co.uk/FactsFigures_SchoolFees.htm.

Planning for complicated lives

The way we live is changing and for most people it is becoming more complicated. For example, 'boomerang kids' are much more common – those are adult children who leave home and then return, typically when times get tough. Nearly a third of men and a fifth of women aged 20 to 34 live with their parents, according to government figures.[1]

Meanwhile, although the figures for divorce are at their lowest for over 20 years, that is mostly because far fewer of us are marrying in the first place. The number of marriages in the UK in 2007 (the most recent statistics) stood at 270,000 with figures for England and Wales the lowest recorded since 1895.[2] When we do marry, it is generally much later in life, in our 30s rather than our 20s, and more of us are delaying parenthood.

Perhaps not surprisingly therefore, the proportion of people who live alone in Great Britain has doubled from about one in every 16 of the population living in private households in 1971 to more than one in eight in 2008.[3]

Someone in their 20s might expect to live alone, either with their parents or in more than one partnership before having children and then possibly getting married and buying a home. A divorce and a new relationship with a new partner with their own children could involve complicated family ties and even property ownership. By the time such a person starts to think about retirement, one or more adult children could return to live at home. And retirement itself is a much more fluid concept, mixing work and leisure. Of course, there are still some people who manage to lead simple and very straightforward lives – but you can't depend on being one of them.

These marked changes in the way many of us are now living have a major impact on personal financial planning which needs to be flexible enough to take these new patterns for families into account. Here are what we believe tips for modern complicated lives:

- Build up some short term savings or rainy day money for yourself. You never know when you might need to draw on savings – separation, divorce, unemployment, short-time working, the non-appearance of an expected bonus.
- Make sure you have enough life assurance cover and that it is arranged so that the potential beneficiaries can be changed as circumstances alter over time. You will need both the cover and the trust wording to be flexible.
- Avoid expensive consumer debt. It may look tempting but it can add hugely to the cost of purchases.
- Have some insurance that pays out if you fall seriously ill; the state does not provide generous sick benefits. And make sure your adult children or other potential dependants have plenty of life and health cover. If something happens to one them, you could be left holding the baby – literally.
- Don't depend on your spouse or partner to do all the saving for retirement; it is a high risk strategy. You may not be together at retirement; they may not save enough for both of you and, in any case, it is generally much more tax-efficient for each partner to have their own source of retirement income.

Versatile and flexible arrangements, coupled with competent professional advice, should help you keep complex family finances running smoothly.

1. Source: www.statistics.gov.uk/pdfdir/sthome0409.pdf
2. Source: www.statistics.gov.uk/cci/nugget.asp?id=322
3. Source: www.statistics.gov.uk/pdfdir/stalone0409.pdf

Escape your bonds?

If you have a one-year bank or building society bond about to mature, you may find that your money is going to be automatically transferred to an account paying minimal interest. For example, Northern Rock pays just 0.25% on its matured bonds.[1] Some deposit takers will roll over your investment into a new bond for the same term, but give you the option of withdrawing penalty-free within a month.

Twelve months ago, when bank base rates were 5%, you could find one year fixed rate deposits paying 7% gross interest. It was a tempting offer, particularly given the turbulence in the stock market at the time.

Now those bonds are maturing and the interest rate picture is very different. Base rates have fallen to 0.5% and the best one year fixed rate bond is offering below 4%. There are slightly higher rates for longer term deposits, but nothing approaching 7%.

If your main goal is income, in the current environment there is no avoiding a substantial fall if you stick to fixed term deposits. However, if you are prepared to accept the risk of losing some or all of your capital, and to commit to investing for at least five years, there is a wide range of investment funds which currently offer higher levels of income than one-year deposits. For example:

- Corporate bond funds, which invest in fixed interest securities issued by companies.
- UK equity income funds, which generally invest in shares with a higher than average dividend yield.
- International equity income funds, which focus on higher yielding shares outside the UK.

All three fund types can be held within an individual savings account (ISA) but do not afford the same capital security as a deposit account. ISAs are particularly suited to corporate bond funds, as the interest from these funds flows through to investors free of UK tax. The investment limit (see 'ISA top-up time') is double the cash ISA ceiling.

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1. Source: www.northernrock.co.uk/savings/saving-rates/fixed-rate/

It'll never happen?

Have you ever considered what would happen to your family finances if you or your partner were to become seriously ill, or even die?

Take the example of a young married couple with two children. The husband earns £40,000 a year and the wife earns £8,000 a year working part-time. They have a recent joint mortgage on their property worth about £130,000. One day the husband is killed in a traffic accident. How would the family fare?

With no life assurance cover at all, not even within the husband's pension scheme, the result would be financial disaster for the family.

Some simple disaster planning could avert real hardship if the worst does happen. Taking out a life policy on both parents that pays out on the first death could be the most effective way of protecting the family – if the primary homemaker is lost, the problems can be just as devastating. The premiums might be lower than you think.

With sensible arrangements to cover serious illness as well, a family's finances would be put on a much sounder footing and the mortgage could even be paid off if there were enough life cover.

It is tempting to think that such a disaster will not happen, and they are relatively rare. But if your family did suffer such a loss, the cover may make all the difference.

How do your prospective pension benefits compare with the national minimum wage (NMW)?
On 1 October 2009, the NMW will rise by 7p to £5.80 an hour for anyone aged 22 or over. That equates to £232 a week for a 40-hour week or £203 for a 35-hour week. In 2009/10, the basic state pension is £95.25 a week for a single person and £152.30 a week for a married couple. That is a reminder, if one were needed, of the dangers of relying on state provision in retirement.

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Year-end planning decisions

If your company's year end is 31 December, now is the time to start considering whether and how you should draw out your profits. In 2009, there is a new set of factors to consider alongside the normal issues:

- The new rules on pensions tax relief for high earners (see 'Higher rate pension relief hits trouble') may limit the appeal of pension contributions.
- The smaller companies' corporation tax rate is due to rise to 22% from April 2010.
- From 2010/11, the top income tax rate will rise to 50% (42.5% for dividends) and personal allowances will be phased out if your income exceeds £100,000.
- The government has so far not taken any definitive action on family company dividends, although it continues to say the matter is under review.

The first two points tend to favour retaining profits within your company, while the other two point to drawing profits out now. If you opt for drawing out profits, the mathematics of the bonus/salary/pension decision (assuming full contribution tax relief is available) for this year is shown below, based on a marginal £50,000 of profits.

If you are not affected by the new pension contribution tax relief rules, directing profits towards your pension could well be worth considering this year for two main reasons:

- Your retirement fund may need rebuilding after the past two years' difficult investment market conditions.
- There is a risk that restrictions on pension tax relief will be tightened further by the next government, whatever its hue.

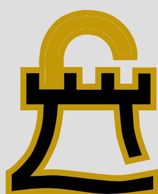
Levels and bases of, and reliefs from, taxation are subject to change.

Bonus v Dividend v Pension

	Bonus £	Dividend £	Pension £
Marginal gross profit	50,000	50,000	50,000
Pension contribution			50,000
Corporation tax	N/A	(10,500)	N/A
Dividend	N/A	39,500	N/A
Employer's National Insurance Contributions (NICs) £44,326 @ 12.8%	(5,674)	N/A	N/A
Gross bonus	44,326	N/A	N/A
Director's NICs £44,326 @ 1%	(443)	N/A	N/A
Income tax	(17,730)	(9,875)	N/A
Benefit to director	26,153	29,625	50,000

Assumptions:

- Company's marginal corporation tax rate is 21% for calendar year 2009.
- Director's marginal income tax rate for 2009/10 is 40% (32.5% for dividends less 10% tax credit).
- Anti-forestalling measures do not apply to the director.



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