FINANCIAL FOCUS

KEEPING YOU UP TO DATE WITH DEVELOPMENTS IN FINANCIAL PLANNING

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Rob Sandwith, Chief Executive

Welcome to the autumn edition of our newsletter and I hope all our clients and readers have had an enjoyable summer.

Autumn means back to school and university, which focuses the mind on rising educational costs for those of us that pay school fees. This edition contains details on government changes effective this tax year, which will almost certainly mean graduates leaving university with ever increasing levels of debt. Planning for these liabilities well in advance will almost certainly pay dividends long term.

Gordon Brown continues to tighten the taxation net and Inheritance Tax (IHT) is the latest revenue-raising tool that is on his radar screen. IHT is paid by almost three times more estates than six years ago, however it is still technically a voluntary tax. With judicious planning it can be mitigated against using simple life assurance policies written in trust.

April 2006 marks a significant change in pension legislation – 22 complex rules become one simple one! Careful plans should be made in the interim to take best advantage. More detail inside.

Please contact us in the office if you want to arrange a review meeting or require further information on any of the articles in this newsletter.

On Your Marks — An Investment Saga

Marks & Spencer dominated the headlines of the business pages in the early summer, when it fought off a potential bid from Philip Green.

Although M&S kept its independence, like Sainsbury's, it has been a sad tale for the majority of its longstanding small shareholders. Both companies were traditionally classed as 'blue chips', but they appear to have lost their way.

If you have a handful of shares, the sagas of M&S and Sainsbury's contain three important lessons:

- Your shareholdings need to be managed because yesterday's blue chips may be tomorrow's also-rans.
- You probably do not have enough time or expertise to give your shareholdings the attention they deserve.
- Diversification is a vital part of investment. If you hold just a few shares, bad results from a couple can have a major impact on your total wealth.

Should you rely on blue chip investments?

In practice, you could be better off abandoning direct shareholdings completely in favour of unit trusts, OEICs and similar investment funds. These give you access to ongoing professional investment management, a well-diversified portfolio and less paperwork. Most of the major investment management groups offer share exchange facilities if you swap your shareholdings for their funds. Why not take a positive decision on your shares and let the experts help you look after your capital?

in this edition. . .

Invest to Boost Your Income

Since the Bank of England started raising interest rates last November, income from most deposit accounts has been steadily increasing. Banks and building societies have not always passed on the full benefit of all the rate increases. Nevertheless, the *proportionate* uplift in interest payments has been significant. An increase of 1% from 3% to 4% represents a one third hike in income.

If you depend on deposit accounts for your income, the upward march of short term interest rates will have come as a welcome reversal. But you should keep matters in perspective:

An increase of 1% interest from 3% to 4% represents a one third hike in income.

- Inflation, as measured by the retail prices index, had risen to 3% by June 2004. If you are a basic rate taxpayer, you need to earn interest of 3.75% gross just to keep pace with price increases. If you pay higher rate tax, you need to get 5% gross.
- Just as short term interest rates are rising now, it is almost inevitable that at some point the trend will be reversed and your interest income will start to fall again.

In the current market, you have a wide range of alternatives to deposit accounts if your primary investment aim is income:

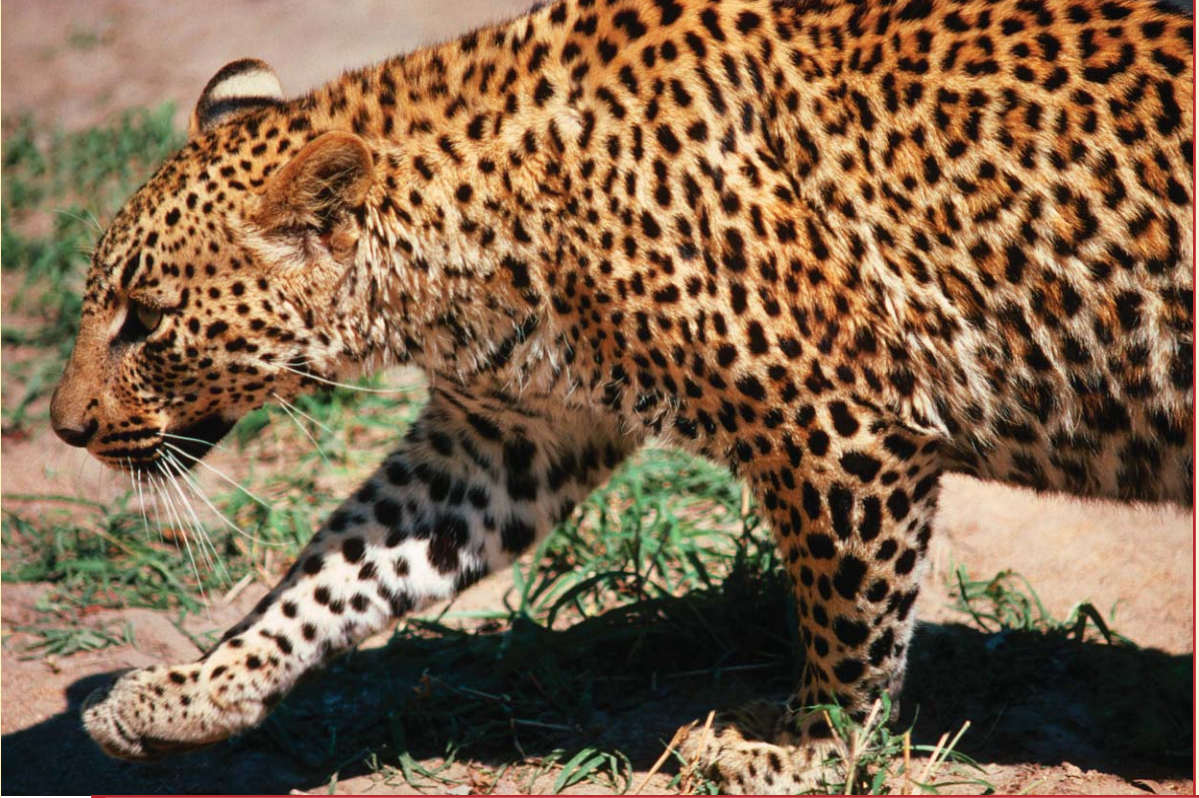
Income bonds The income yields on offer from guaranteed income bonds have become more attractive with the rise in medium term interest rates. And guaranteed income bonds can be particularly tax efficient if you are a higher rate taxpayer. At current income rates, all your personal tax liability is deferred until the bond matures and even then you only pay additional tax (at 20%) on the *net* income you have received. With a normal deposit account, your additional tax is based on the *gross* interest. If you receive £800 from a deposit account, the higher rate tax is £200. From a guaranteed income bond it is only £160.

Corporate bond funds normally offer higher income yields than deposit accounts, with interest payments not linked to the vagaries of bank base rates. Virtually all corporate bond funds are available for ISA and PEP investment, which means you can receive interest completely free of UK income tax. Some funds even offer monthly interest payments.

UK equity income funds offer potential long term income growth, but typically with a lower initial income than from corporate bond funds. There should also be more scope for long term capital growth from equity funds, although this cannot be guaranteed.

Distribution funds Many major investment managers are now offering this halfway house between corporate bond funds and UK equity income funds. These types of funds hold both bonds and shares and aim to combine the long term potential from equities with the relative stability and high income levels of corporate bonds.

It is important to remember that corporate bond funds, equity income funds and distribution funds do not guarantee to return your capital – unlike deposit accounts. Which of these investments suits you will depend on a variety of factors, including your attitude to risk. Of course, deposits are not completely without risk. As we have all seen, interest rates can go down as well as up.



Creeping Tax Changes Catch the Unwary

It can be tempting to think that your tax planning does not need to change. There was a time when you knew where you were with your tax. Successive Chancellors would use their Budgets to tweak the edges, but generally one year's tax rules were pretty much like the following year's. This is no longer the case.

More recently, the tax regime has been in an almost constant state of flux. You may not have noticed it, but the constant and complicated changes could have affected you in a wide variety of ways:

- The tax reliefs for PEPs and some ISAs have been reduced and from 6 April 2006 the maximum investment level will fall from £7,000 to £5,000. You may now have the wrong type of funds in your plans.
- Tax on the income and gains of trusts has increased considerably, to the extent that it can sometimes be better to avoid the use of trusts.
- Company car tax has changed radically. You could now be better off having a company car solely for private use, rather than extra salary.
- Children's tax credit arrived and, after a mere two year life, was replaced by child tax credit. Tax credits have been one of the Chancellor's big ideas, but they are not just the preserve of those on low incomes – you can be a higher rate taxpayer and may still receive tax credits.
- The rates of national insurance contributions (NICs) have been raised and NICs' reach extended, notably by the infamous IR35 attack on one person companies.
- The tax rules for personal pensions were overhauled three years ago and are now set to be reformed yet again from April 2006 as part of pension simplification.
- Inheritance tax has been complicated by the addition of a steady stream of compliance measures to stop tax avoidance.

Inheritance tax also highlights another aspect of the tax system that may have affected you. The Chancellor has generally increased tax allowances and bands – but only in line with changes in retail prices. As earnings and property values have risen faster than general inflation, more and more people have become 40% taxpayers on their income and have been dragged into the inheritance tax net. There have recently been controversial proposals from a think-tank to increase the top rate of IHT to 50% and introduce a 22% lower band, although the government seems to have distanced itself from these ideas.

After so many changes, it makes sense to step back and examine your current tax planning strategies. Such an assessment is definitely not in DIY territory, so why not give us a call to arrange a meeting? Who knows, after a review, life could prove to be a lot less taxing.

Reducing the Impact of Debt on Students

Students who go to college or university in Autumn 2006 will face an enormous increase in their debt when they graduate. This could limit their ability to raise a mortgage.

The difference between the current set of tuition fees and the new system starting in 2006 is significant:

- Under the current system, in England and Wales tuition fees for the 2004/05 academic year are £1,150 a year, regardless of course or college. The flat fee, payable up front, has steadily risen by £25 a year since it was introduced. In 2006/07 it is likely to be £1,200.

- From 2006/07 onwards, universities will normally be able to set their own tuition fee levels for new entrants (except for gap year students starting courses in Autumn 2005 but going to university a year later, who avoid the higher fee). The fee, which will be subject to an initial maximum of £3,000, can be financed by a student loan. The fee loan will operate in a similar way to existing maintenance loans. So no interest will be charged, but the outstanding debt will be revalued in line with inflation and be repayable from earnings after the course ends.

It seems likely that most universities will charge the maximum £3,000 fee, given the parlous state of their finances.

The government has made several other reforms to student finance in an effort to counter the impact of higher tuition fees. For example, for 2004/05 the student grant has been reintroduced and in 2006/07 a 'fee grant' will also be payable. In practice, the changes are primarily aimed at encouraging children from low income families to attend university. For example, this year's new grant of up to £1,000 is phased out completely if parental income exceeded just £21,185 in 2003/04.

Even if all the effects of inflation are ignored, from 2006/07 a student living away from home who draws the maximum non means-tested maintenance loans and £3,000 a year tuition fee loans could face a debt on graduating after three years of over £17,800 (over £19,800 for a London college). This compares with an average starting salary for new graduates in 2004 of £21,000, according to the Association of Graduate Recruiters.

If you are a parent looking to help your child or children through higher education, these changes make planning to meet the costs all the more important. Without some provision, your child could start working life with a debt nearly equal to their first year's gross pay.

Juggling with Corporate Tax Planning

Each year company owner directors have to decide whether to draw a bonus or dividend from their profits. This decision is usually best made before the year end and for many companies this will be Friday 31 December. The basic calculation, shown below, on the whole favours dividends for small companies. This has generally been the case for some years.

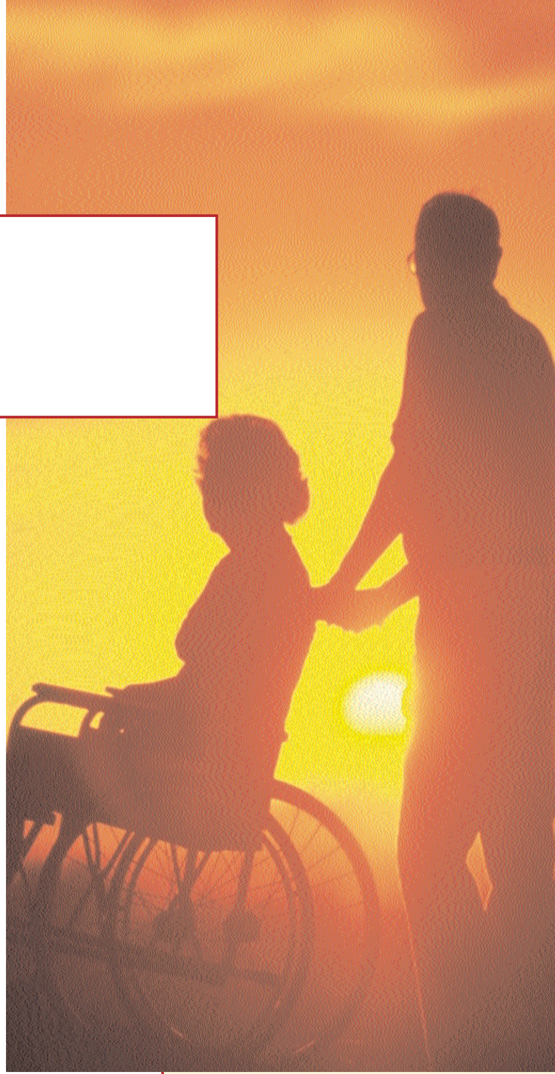
The table shows the position of a shareholding company director who can choose between taking out £10,000 of company profits as a bonus or as a dividend. The bonus would attract national insurance contributions (£1,135 for the company and £89 for the director personally). There would also be income tax on the bonus at 40% of the gross bonus after the employer's NICs.

In contrast, taking the profit in the form of a dividend would avoid the NICs, but it would mean the company paying 19% (£1,900) corporation tax on the profit. The only other liability would be higher rate income tax of £2,025 (25% of the net dividend).

The introduction of a minimum 19% corporation tax on profits paid as dividends (other than to

Suppose you were unable to work for at least six months because of an accident or illness, who would pay the bills?

"It won't happen to me – I'm never ill."



If you are an employee, your employer might continue to pay you for a year or so, but after that you could be left to fend for yourself. If you are self-employed, matters are clearer cut: your earnings will normally stop when you stop working.

The state offers some help, but it is hardly generous. Long term incapacity benefit (payable after 52 weeks) is just £74.15 a week. You might also receive an extra £44.35 a week if you have a dependent spouse who looks after your children. Additional payments for children are now wrapped up in Child Tax Credit. Further help, eg income support, will usually be means-tested, which would currently exclude you if you are under age 60 and have assets (other than your home) worth more than £8,000.

As at March 2003, there were nearly 2.4 million people claiming sickness, incapacity or invalidity benefit.[1] Many of those people probably thought – as you might be thinking now – 'It won't happen to me – I'm never ill'. Yet, as the investment advertisements always remind you, past performance is not necessarily a guide to the future. Today's robust health can disappear suddenly, perhaps as the result of an accident or possibly some ailment that has been lurking, unnoticed, for several years.

The best way to handle the issue of ill health is to recognise that it might happen to you and arrange suitable insurance cover. To protect your income, the simplest solution is income protection insurance (sometimes confusingly called 'permanent health insurance').
This type of cover can:

- Run until you reach your planned retirement date.
- Pay you a tax-free income of up to about 60% of your gross earnings until you return to work or you reach your planned retirement age if that is earlier.
- Be set up so that payments start after a specified period off work, eg three months or 12 months.
- Include automatic inflation protection, so that the value of payments is not eroded if they continue for a long period.

Income protection is also valuable for those who look after the home. If the homekeeper falls ill, income protection can help meet the costs of all their unpaid duties, to cover anything from the children's taxi service to laundry and domestic chores. Without such cover, the breadwinner may need to give up their job, and suffer the inevitable financial consequences.

1. *Source* www.nationalstatistics.gov.uk/StatBase/Expodata/Spreadsheets/D3993.xls

companies) has not changed matters for many businesses. However, it has hit some of the very smallest of companies, typically one man bands, with gross profits of under £50,000.

Nevertheless for most smaller companies, dividends are still generally more tax efficient than bonuses. In this case the director's net income from the dividend is over a sixth higher than from the bonus.

Bonus or Dividend?

	Bonus £	Dividend £
Marginal gross profit	10,000	10,000
Corporation tax	N/A	(1,900)
Dividend	N/A	8,100
Employer's National Insurance Contributions (NICs) @ 12.8%	(1,135)	N/A
Gross bonus	8,865	N/A
Director's NICs @ 1%	(89)	N/A
Income tax	(3,546)	(2,025)
Net income to director	**5,230**	**6,075**

Assumptions:
- The company's marginal corporation tax rate is 19%.
- The director is a higher rate taxpayer.

Flexible Way to Provide More Protection for Growing Investments

Are you looking for an investment that gives you the potential for stock market growth, but with the peaks and troughs cut down to manageable levels?

Not so long ago, the most common answer to such a search was a with profits bond. However, there is now a new type of investment that aims to provide a smoothed investment ride, while avoiding the actuarial complexities of with profits plans. This new investment goes under a variety of different names, although usually a variant on the word 'protected' is contained in the title.

'Protected' is an accurate description because the investment goal is protection, rather than any guarantee. A typical fund will aim to limit any fall in the unit price to no more than 20% of the highest ever price level. For example, if the peak price of the fund was 150p, then the fund price should not drop below 120p.

All these funds work on the same principle, which has been tried and tested across a variety of market conditions. The protected fund itself has two main holdings: a cash fund and an equity fund. The split between the two is regularly varied in response to market conditions, using a simple mathematical rule. When share prices are rising, the equity fund content is increased (but normally it is never over 80%), whereas if share prices fall, more is moved into the cash fund. At any one time, the balance between the two holdings aims to provide the maximum possible exposure to shares consistent with the capital protection offered.

It is important to remember that corporate bond funds, equity income funds and distribution funds do not guarantee to return your capital – unlike deposit accounts.

Unlike many other investments that offer an element of capital protection, these new funds do not have a fixed investment term or a time-limited issue period. You can invest when you want, for as long as you want, although you should not consider these funds as an alternative to short term deposits, and should look to invest for at least five years.

Pension Tax Overhaul

The new tax rules for pensions that start in about 18 months on 6 April 2006 (A Day) will open up valuable new planning opportunities. But many people should start their planning now to make the most of the changes, many of which are very radical.

Would extra salary or bonuses now help you to obtain more tax-free cash after A Day? The special transitional rules that apply to occupational pension scheme cash entitlements can make it worthwhile to boost your earnings now, even though there is a national insurance contributions cost for doing so.

Should you maximise contributions while you can? If the value of your pension benefits is currently near to or above the lifetime allowance (£1.5m in 2006/07), it may not make financial sense to add to your pension plan once the new rules are in force. However, funds built before A Day can be protected from any tax penalty.

Do changing investment opportunities mean that you should make the maximum contributions now? For example, you might want to take advantage of the possibility of investing your pension fund in residential property after A Day.

The answers to these questions depend upon your personal circumstances and objectives. Ask us to review your pension planning before A Day.

This year's Finance Act contained what many experts saw as retrospective inheritance tax (IHT) legislation. In the government's view, the new law was not retrospective, but retro-active and it was not an IHT charge but a freestanding income tax charge. These fine distinctions may be lost on those affected, some of whom could have made gifts as long ago as March 1986. They could now face the problem of either accepting that the gifts never happened for IHT purposes, or paying an income tax charge based on a notional value of the gift from next tax year.

Try A Simple Solution to Inheritance Tax

House prices lead to record inheritance tax.

One lesson from the new legislation is that the government is determined not to see the revenue from IHT disappear as a result of sophisticated estate planning techniques. Lifetime gifts receive generous treatment under IHT – they normally disappear from the IHT calculation if the donor survives for seven years after making the gift.

However, this year's Finance Act underlines the fact that the gift must be a genuine, outright gift. Any attempt to have your cake and eat it too in terms of retaining a benefit from the gift is liable to lead to a tax charge of one form or another. For all but the very rich, this limits the scope for benefiting from the favourable lifetime gift rules.

Before the era of complex IHT avoidance schemes, planning for IHT used to be much more straightforward:

- You arranged your wills as tax-efficiently as possible, making sure that there was adequate provision for the surviving spouse/partner. Usually this would mean avoiding any IHT bill on the first death of a married couple.
- You calculated how much the potential liability to IHT would be after both spouses had died.
- To meet that potential IHT bill, you took out a joint life, last survivor whole of life policy written under a simple trust for the beneficiaries of your will.
- Regular premiums were paid until both of you had died. Usually these were covered by IHT annual exemptions and therefore attracted no tax.

This simple process meant that generally the taxman and beneficiaries both received what they expected. In the new world of tougher anti-avoidance laws, it is likely that this straightforward whole of life assurance approach to IHT planning will regain some of its former popularity. To see how much such a solution would cost you, why not ask us to work out some figures?

Don't Forget the January Tax Deadline

An important day in the tax calendar and a Monday not to miss is 31 January 2005. Three tax-related deadlines fall on that day, any of which it could be costly to overlook.

Filing Date for Your 2004 Tax Return

The Inland Revenue probably sent you your tax return in early April unless you filed via the internet last year, in which case you will have simply received a reminder to file by way of the net for this year. If you have done nothing about the return so far, now is the time to start gathering the papers you need. It pays to avoid waiting until the last minute because you might need to chase up missing information, such as lost dividend tax vouchers or interest statements. If your tax return is filed late, you face an initial penalty of £100, or the amount of tax outstanding if this is less. A late return might also encourage the Inland Revenue to take a closer look at your affairs.

Tax and NIC Payments

Any capital gains tax and balance payments of income tax and Class 4 national insurance contributions (NICs) for 2003/04 are due on 31 January 2005. The NICs element could come as a nasty surprise, because 2003/04 was the first year in which the extra 1% charge applied. This increase would not have been allowed for in your January 2004 and July 2004 payments on account, because they were based on your 2002/03 tax and NICs bill. For example, your Class 4 NICs bill would be £490 higher in 2003/04 than 2002/03 if you had self-employed earnings of the same £50,000 in both years.

Your first payment on account for the current tax year (2004/05) is due alongside the sums due for 2003/04. If you pay after 31 January you will be charged interest, currently at a rate of 7.5%. This might seem a reasonable borrowing cost, but there is a catch. If your payment is more than a month late, a 5% surcharge will also be applied.

Make sure you make the deadline.

Personal Pension Contributions

One way to speed up the receipt of higher rate tax relief on your personal pension contributions is to backdate them to the previous tax year. As a result of changes introduced in 2001, to backdate a contribution to 2003/04 you must now pay the contribution by 31 January 2005 and make a backdating election to your pension provider *no later* than the contribution date. If you are a higher rate taxpayer, the result will usually reduce the total amount you are due to pay on 31 January (or mean you get a refund or increase your refund). The one thing a backdated contribution will not do is alter your payments on account for 2004/05.

EU Savings Directive

After much wrangling, the EU Savings Directive is now due to begin operation on 1 July 2005. The name is somewhat misleading, as its main thrust is to ensure tax is collected on the overseas investment holdings of EU nationals. For example, if you hold Luxembourg fixed interest funds, you will no longer receive income payments without tax deducted.

National Savings & Investments Limits

Such is the government's need for cash, it has increased the amount that can be invested in NS&I fixed rate and index-linked savings certificates from £10,000 to £15,000 per issue. However, the rates on offer are still not exciting, particularly for basic rate taxpayers.