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.

Spring this year marked the first real set back for stock markets since the latest bull phase started in March 2003. At the time of writing markets are close to recovering from their May lows, but this highlights the need to keep on top of risk profiles and maintain diversification generally.

This edition focuses on related topics, such as the importance of reviewing the mix of existing ISA and PEP portfolios. Some married clients now have over £500,000 invested in these assets and constant review is therefore recommended.

With the introduction of the new pension regime last April, many clients have requested clarification on annuity purchase and the treatment of benefits after retirement. This newsletter contains a summary of the main changes.

We have just concluded a comprehensive upgrade of our web site, with new information on private education and university fees, retirement planning, SIPPs and, for the first time, the ability to buy our preferred funds without advice through 'Rosan Select'. Funds can be purchased either inside or outside the ISA wrapper and then monitored online.

The site also allows the research and purchase of life assurance and mortgages. I would urge you to visit www.rosan-ifa.com.

Please contact us if you require further information on any of the articles.

Wake up to the new pensions rules

Pension planning was revolutionised in April, but many people have still not woken up to the new opportunities, let alone started to exploit them. Although it is still early days for the new regime, several themes are emerging:

- Interest in self-invested personal pensions (SIPPs) has grown dramatically over the last year. Now you can choose virtually any fund, whether onshore or offshore, for your pension.
- Some people have started to save on the cost of basic life cover by moving from traditional term assurance to pension term assurance, which gives you full income tax relief on premiums.
- Some employees are adopting a new approach to their pension contributions. It is now much simpler to turn your taxed bonus into a tax-relieved pension contribution.
- Employees nearing retirement are finding they can draw more tax-free cash from their pension scheme.
- The new alternatively secured pension (ASP), which gives you the opportunity to avoid ever having to buy an annuity, has attracted considerable attention.

One aspect of pension planning is unchanged: the need for expert advice. The rules are simpler, but they are not suited to a DIY approach. If you want to make the most of the new regime, you need to start by talking to us.

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The future pensions jigsaw

One of the most intractable problems the government has tried to tackle has been pensions. The latest instalment is the government's Pensions White Paper that sets out its vision of the future for providing state and private pensions.

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The paper adopts many of the ideas made by Lord Turner in his earlier Pensions Commission, although seasoned observers of the government may detect the hand of the Treasury in some of the cost-cutting changes to the earlier proposals. All pensions require long lead times. So the first changes will not begin to take place until 2010 and the final adjustments may not occur until around 2030.

The following is a quick guide to the government's plans and how they could affect you.

- **Basic State Pension** Increases in the basic state pension will be linked to the average growth in earnings, not just the significantly lower annual rise in prices, starting sometime between 2012 and 2015. The earnings link will not extend to S2P (the state second pension) or its predecessor SERPS.

  It will take only 30 years of national insurance contributions (NICs) to qualify for the full basic state pension. The qualifying period is currently 44 for men and 39-44 for women. This change will take effect from 2010 and should be a major help for people who take career breaks and find it hard to achieve a full contribution record. At the same time, the requirement to make NICs for at least a quarter of the qualifying period to receive any pension entitlement whatsoever will be scrapped.

- **State Pension Age** is set to increase by one year starting in about 18 years' time, and then again, starting in about 28 years' time and finally again starting in about 38 years. By 2046 the state retirement age is due to be 68.

- **Pension Credit** will be reformed, reducing the benefit for those with a private pension and/or investment income. Even so, the White Paper estimates that by 2050, around a third of all pensioner households will still have such low incomes that they will be eligible for pension credit.

- **State Second Pension** (S2P) will gradually become a flat rate pension rather than earnings-related, with the phasing process probably ending around 2030. The option of contracting out of S2P via a personal pension or other money purchase scheme will probably end around 2012. Contracting out via final salary pension schemes will continue, but it too looks likely to disappear eventually.

- **Personal Accounts** will be new pension plans for employees who are not already members of good pension schemes. They will be automatically enrolled, though they will be allowed to opt out if they wish. The aim is for employers to contribute 3% of earnings, employees to contribute 4% and the government – through tax relief – to contribute 1%. These contributions will be based on earnings subject to full NIC rates between £5,035 and £33,540 in 2006/07 terms.

These changes could turn out to be good news for low earners, but if you are further up the income scale, you may find yourself worse off because of the move to a flat rate S2P and the higher pension age.

One thing has not changed: for most the route to a comfortable retirement remains through private provision, not dependency on the state.

Inheritance tax revisited

If you think inheritance tax does not apply to you, you should probably think again.

The inheritance tax (IHT) net is extending rapidly. The total number of estates paying this tax rose by nearly three-quarters over the five years to 2003/04, according to research recently undertaken by the Halifax.[1] The research was based on data from HM Revenue & Customs (HMRC) and also shows that the government expects the number of estates paying the tax to rise by a fifth by the end of 2006/07. What is more, over the past five years IHT revenue has leapt by nearly 50%.

And you do not need to be rich to be hit by IHT, membership of the IHT 'club' is far from exclusive. One of the more surprising results from the Halifax's mining of the HMRC statistics is that in 2003/04, more than seven out of ten estates suffering IHT were worth less than £500,000.

So what is driving this IHT bonanza for the government? It is a combination of two factors: rising house (and other asset) values combined with a tax threshold that increases very sluggishly each year – in 2006/07 tax at 40% is charged on estates (including homes) to the extent that they exceed a mere £285,000.

The Halifax calls on the government to raise the inheritance tax threshold to £430,000 to allow for the increase in property prices over the past ten years. The trouble is that there is very little chance of this happening, despite a former cabinet minister calling for the abolition of IHT:

- In this year's Budget, Mr Brown announced the levels of the nil rate band threshold right through to 5 April 2010 – by which time it is due to be just £325,000. The aim of this ploy was to kick the issue into the long grass until after the next election.

- What is more, the Treasury shows every sign of needing all the revenue it can raise: it simply does not seem to be in the business of cutting your taxes. IHT currently yields over £3 billion a year – and rising.

If anything, the Chancellor seems intent on widening the scope for IHT, judging by the moves in the last Budget to counter the use of trusts. The new rules are now in place, and generally took effect from Budget day (22 March 2006). They have complicated IHT planning in some areas, particularly for very large lifetime gifts, but there are still many strategies available that will allow you to make transfers out of your taxable estate and still provide you with a high degree of access to the funds.

The changes mean that you should review your estate planning soon and regularly. It is not just your circumstances that change: the law is constantly evolving – sometimes suddenly and unexpectedly. Many of the standard approaches to planning are no longer appropriate and should be amended as a matter of urgency. It is especially important to review your will, as well as any trusts that you may be involved with. Levels of, bases of and reliefs from taxation are subject to change and their value depends on individual circumstances.

1. *HBOS plc Press Release, 5/8/2006.*

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New year end strategies

New Year's Eve is the most popular single date for companies to set their year end. With a 31 December year end, the accounting business year and the calendar year conveniently coincide.

Well before Sunday 31 December 2006 you should have executed your year end corporate planning. Ideally you should be thinking about the year end tactics now, before the assorted distractions of December and Christmas start to appear.

This year your options have changed yet again. The main rules and rates for income tax are basically the same, but corporation tax has been slightly altered. In the March Budget, the Chancellor scrapped the £10,000 nil rate corporation tax band together with the associated complex non-corporate distribution rules. This move only affected companies with gross profits of less than £50,000.

Assuming your profits exceed that level, the choice between whether to draw a bonus or dividend works out in the same way as last year, as shown in the table below. Dividends remain the better route if your company is in the 19% corporation tax band.

Bonus or Dividend?

	Bonus £	Dividend £
Marginal gross profit	**50,000**	**50,000**
Corporation tax	N/A	(9,500)
Dividend	N/A	40,500
Employer's National Insurance Contributions (NICs) £44,326 @ 12.8%	(5,674)	N/A
Gross bonus	44,326	N/A
Director's NICs £44,326 @ 1%	(443)	N/A
Income tax	(17,730)	(10,125)
Net income to director	**26,153**	**30,375**

Assumptions:

- Company's marginal corporation tax rate is 19%.
- Director's marginal income tax rate is 40% (32.5% for dividends).
- All bonus or dividend assessed at 40% or 32.5 % respectively.

The major change for this year has occurred on the pension front, thanks to the arrival of pension simplification in April. In theory, in 2006/07 you and your employer(s) can normally obtain tax relief on contributions up to a total of £215,000 to your pension arrangements, whatever your earnings.

The employer contribution must be justifiable as a business expense, so in practice, a very large employer contribution might possibly not gain full tax relief. Nevertheless, in nearly all situations there is now much greater scope than in 2005 to divert profits to your pension plan.

It is not only the contribution potential that is higher, but your pension choice is wider too. For example, even if you are a member of an executive pension plan or small self-administered scheme, your company can now contribute to a personal pension on your behalf. So, before 2007 arrives, your company could fund a self-invested personal pension completely separate from the business, where you can make all the investment decisions.

The new pension options are well worth exploring, but do make sure you leave enough time to do so.

£3,000 tuition fees begin

If you have a child starting college, you probably do not need reminding that the new academic year is the first when tuition fees of up to £3,000 a year will apply for new students living in England. Although £3,000 is the maximum fee set by the government, in practice very few colleges have opted to charge anything less than this figure, such is the state of university finances.

Fortunately the fees no longer have to be paid up front. Instead students can apply for a 'Student Loan for Fees' to cover the costs. This means that the fees are paid direct to the college, on the student's behalf. Once students have left university and are earning over £15,000 a year, they have to start repaying these loans.

The tuition fees loans will sit alongside the loans given for maintenance, which in 2006/07, for a student studying outside London, can be up to £4,405 a year. Maintenance grants are available, but the Department for Education and Skills says that only about half of students will be eligible for any grant payment. They are not available where annual household income exceeds £37,425.

The combination of loans for the new higher tuition fees and maintenance could easily mean that, at the end of a three-year course, a student will owe more than £20,000. That compares with a projected average salary for 2006 graduates of £23,000. 'Interest' is charged on the debt at the rate of RPI inflation (roughly 2.5% a year if the government meets its targets), while repayments are 9% of gross earnings over £15,000. A graduate with £20,000 debt will begin work with a £500 yearly interest bill, assuming 2.5% annual inflation.

This is cheap debt: interest on the same amount borrowed as a mortgage would be £1,350 a year at current standard variable rates. When deciding which debt to pay off first, clearing student debt may not be the highest priority in relation to other loans. That is not to say that you should not plan to provide some financial assistance to your children during and after their college years. The point is that there could be better things to do than clear low-cost loans.

The annuity alternative

For some people – like Plymouth Brethren – buying an annuity is against their religion. A number of other investors coming up to retirement also object to being forced to buy an annuity when they want to draw benefits from their pension. They don't like the inflexibility, the apparently low returns or the position when they die.

Of course, annuities do have their advantages. They can provide a really secure income and they are normally guaranteed to last as long as you live. In fact they can be regarded as a type of insurance against living too long.

The new pension simplification regime introduced this year abolished the requirement to buy an annuity by age 75. Unless you have already bought a lifetime annuity or something very like it called 'a scheme pension', at age 75 you can now:

- *Either* buy an annuity or a scheme pension,
- *Or* switch to an 'alternatively secured pension' (ASP).

This alternatively secured pension is a restrictive form of pension fund withdrawal:

- The maximum you can withdraw is about 70% of what an annuity could provide at age 75. If you do not need the income, you can choose to withdraw nothing at all and leave your fund to build up.
- These maximum withdrawal rates are reviewed every year (though they are always based on age 75), so your income could fluctuate, particularly if your drawings have been relatively high.

The low level of withdrawal and frequent reviews are designed to prevent rapid erosion of your pension fund, although this cannot be guaranteed.

ASP is not for you if you are unprepared to accept investment risk and/or would be heavily reliant upon the ASP income.

One reason why increasing numbers of people are choosing the ASP route is the treatment of the death benefits. What you are allowed to do depends crucially on whether you have any dependants alive at the date of your death. 'Dependant' in this case means spouse, civil partner or someone who is basically financially dependent on you.

- If you die leaving any dependants, then the remaining ASP fund must be used to provide an income for at least one of these dependants. The dependant could take his or her benefits by fund withdrawals or ASP, so that when the dependant dies, there could also be some funds available. If there are more dependants left, they can continue drawing benefits, otherwise the remaining funds are treated as below.
- If you die leaving no dependants whatsoever:
    - Your residual fund could be transferred to other members of your pension scheme, for example your children, whom you can nominate. This fund would be liable to inheritance tax.
    - The fund could be paid to any charity you nominate, free of inheritance tax.

Most leading pension providers are now offering ASP arrangements. It is essential to get advice from a specialist and, most importantly, a full assessment of whether ASP could be the right option for you.

Do your PEPs lack pep?

The first personal equity plans (PEPs) will be 20 years old by the time 2007 begins. Even the most recently purchased PEPs will be over seven and a half years old. PEPs were replaced by ISAs from 6 April 1999, but according to HMRC's latest (!) statistics there was still over £70,000 million invested in PEPs in April 2005 – more than was then invested in stocks and shares ISAs.

Your PEPs still offer you a number of important tax benefits:

- Income received is generally free of UK income tax, although UK dividend tax credits cannot be reclaimed.
- Gains are free of capital gains tax.
- There is normally nothing to report on your tax return and no records that need to be kept for the tax authorities.

The tax advantages should not mean that your PEPs are locked away in a bottom drawer. After all, a PEP is not an investment in its own right, but simply a tax-efficient way of holding investments. While you cannot put new money into PEPs, normally you can change funds within a PEP or transfer the value of your investment to a different PEP provider.

The transfer option will often have the advantage of giving you access to a modern 'open' style PEP. This type of PEP, which hardly existed when most PEP investments were originally made, offers you a very wide choice of funds across virtually all of the major investment groups. Once invested in an 'open' plan, you will find it very much easier, quicker and usually cheaper to switch funds – and fund managers – in the future.

Like any other investments, the holdings in your PEPs should be regularly reviewed. Our normal PEP review would examine questions such as:

- How has the fund performed?
- Have there been any changes to the funds (eg a new manager) that alter their future prospects?
- Are the funds still the right investments for you to hold in a PEP from a tax viewpoint?
- Is there an adequate range of alternative funds available within your PEP?
- How do the holdings fit into your overall investment portfolio?
- Are the funds consistent with your current investment goals and attitude to risk?

One area often highlighted by a PEP review is lack of investment diversification. For a variety of reasons, many PEPs were invested in UK equity funds, especially equity income funds. The tax advantages of keeping such funds in a PEP are now much less than they used to be.

If your need is income, then from a tax viewpoint you may be better switching to fixed interest funds. If your goal is growth, then it could make sense to diversify away from the UK, for example into global growth funds. A new investment may not equal or outperform the original. Values may go down as well as up and you may not get back the full amount invested.

And don't forget your ISAs…

ISAs are just as transferable as PEPs and, with virtually identical tax benefits, they are best reviewed at the same time as PEPs.

A different twist on income

If you want an investment that includes shares and you want a high income, then the traditional solution has been to invest in UK equity income funds.

However, with the UK stock market currently yielding around 3%, few UK equity income funds now yield much over 3.5%. Even after the base rate rise, this compares reasonably well with deposit accounts, although unlike a deposit, the value of your investment can go down as well as up.

If you want a higher income, there are currently a small number of funds that offer a markedly higher yield – up to around 7% – while still providing some exposure to equity markets.

These funds have a variety of structures, but a key feature they have in common is the use of an investment technique that turns potential future capital gain on shares into an immediate income. This approach has recently become more readily available for funds marketed to the public, although the large institutions have taken advantage of the strategy for many years. The high income has a price in terms of correspondingly reduced growth prospects for the fund: there is, as you would expect, no such thing as a free lunch or free extra income.

The value of investments and the income from them may go down as well as up and investors may not get back the amount originally invested. The yields quoted are estimates and are not guaranteed. These funds make use of derivatives that involve a higher degree of risk and can be more volatile than equities.

Want less risk?

If you want a fixed, guaranteed income, ask us about the current income bond offers. These can be particularly attractive for higher rate taxpayers.

31 January deadline looms

Wednesday 31 January 2007 is the final date by when HMRC should receive the 2005/06 tax return sent to you last April. If it is still sitting untouched, do not ignore it much longer.

Every year around 10% of people who receive a tax return fail to file it in time. If you become part of that minority:

- You face an initial late filing penalty of £100, (or the outstanding tax due, if less); and
- You raise your profile with HMRC, increasing the possibility that you will be singled out for a future investigation.

31 January is also the due date for any 2005/06 balancing payment of income tax and Class 4 NICs, any 2005/06 capital gains tax and the first of any payments on account for 2006/07. If you do not complete your tax return, you are unlikely to know the right numbers for these payments.

Any delay in payment attracts an interest charge, currently at a rate of 7.5%. And, if you do not pay by 28 February, a 5% surcharge is also applied to the amount due. Another 5% is levied after the end of July, plus another penalty if the tax return has still not been filed.

One change for this 31 January is that there is now no longer the opportunity to cut your balancing payment by backdating a personal pension contribution. The administrative complexities of backdating were simplified away by the new pension tax regime.

There is some logic in this change. The new rules generally allow much greater pension contributions, making the process of catching up on missed contributions far less important. If you want to cut your tax bill with a pension contribution, you can only do so 'in year' now.

There is one piece of transitional relief that might help you, however. If you made a contribution to an old (pre-July 1988) retirement annuity in 2005/06, you still have a chance to backdate that to 2004/05 with a claim made by 31 January.

With profits policies – time to review

Do you have a with profits bond, with profits pension plan or other with profits policy?

The world of with profits policies has greatly changed in the last half dozen years. For example, over half of the insurers involved in with profits now run closed funds, according to a report issued last year by the Financial Services Authority (FSA).

Alongside the closures there have also been several sales of closed funds to new, specialist owners. For example, if you have a policy from companies as diverse as Royal & Sun Alliance, Britannic or Swiss Life, you are now under the wing of Resolution plc. The trend is continuing: in September Resolution completed the purchase of Scottish Mutual and Scottish Provident.

The closure of a fund or its sale does not necessarily mean that future performance will be poor, just as remaining open is no guarantee of success. As the FSA said in its 2005 report, 'performance depends squarely on which fund a policyholder has invested in and also what type of policy they have in that fund.'

Undertaking a review of your with profits policy is a task best left to experts. Here are some of the questions we typically consider:

- Does the policy still meet your needs?
- What level of guarantees does the policy offer?
- How large is the projected maturity value assuming a realistic investment return?
- How has the insurance company invested the portfolio underlying the with profits fund?
- Is the life company financially strong?
- Is the life company offering you a reasonable surrender value for your policy?
- Are there any options for an internal fund switch and are they worthwhile?
- Does the policy contain any options to cash in without penalty at a pre-set time?

Do not surrender or switch a with profits policy without taking specialist independent advice; this is one area where do-it-yourself financial planning can be very expensive.

A new investment may not equal or outperform the original. Values can go down as well as up and you may not get back the full amount invested.

Long-term gifts to children

Would you like to give your children (or grandchildren) something different this Christmas? One idea could be to make an investment that they can access in later life. Many young adults will start their working lives with £20,000+ debts. Money set aside for that day, even if it is not drawn upon, could help provide an element of much-needed financial stability.

There are a variety of ways that investments can be arranged for the under-18s, including:

- **Child Trust Fund** The Chancellor's Child Trust Fund (CTF) has not been as popular as he might have hoped, but it does offer a tax-efficient way of saving for children born on or after 1 September 2002. In total £1,200 can be added to a CTF each year, based on the child's date of birth. A child can have only one CTF, although it is possible to transfer between CTFs. If the CTF is your child's, the CTF's freedom from any income tax and capital gains tax liability is an important advantage over most other types of investment. On the other hand, one drawback is that the CTF becomes the child's to deal with as soon as they reach 18.

- **Designated Accounts** The simplest way to make a gift of unit trusts or open-ended investment schemes (OEICs) is to use a designated account. For example, Tony Smith could buy OEIC shares for his son Alistair by opening an account designated as 'Tony Smith A/C AS'. This approach avoids the need for trust documentation and means that the investment managers will send all correspondence to Tony, not Alistair. Once Alistair reaches 18 he can gain control of the investment, but before then Tony can make all the decisions.

  On the tax front, there is some good news: your child's capital gains are taxed as his or hers and so up to £8,800 of gains will be tax free, even if the gift came from you. Taper relief would also apply to gains once investments had been held for over three years.

  But remember if you make the gift as a parent, any income generated would be taxed as yours if the total income from all gifts you have made to your child exceeds £100 in a tax year.

  These income tax rules do not apply if the gift originates from someone other than a parent, eg a grandparent. In that case the income is taxed as the child's. The result would usually be no tax charge, as every child – however young – has a personal income tax allowance (£5,035). In order to substantiate the fact that this is an irrevocable gift, it is usually advisable to also complete 'a deed of gift'. We can also help you with this.

- **Trusts** The use of trusts has been complicated by the various tax changes introduced in recent years, including those announced in the last Budget. Placing many types of investment in trust can prove tax-inefficient because trusts generally pay the same rates of tax as higher rate taxpayers. However, there remain some investments and trust strategies that do still offer tax savings, if executed properly.

Levels of, bases of and reliefs from taxation are subject to change and their value depends on individual circumstances. The value of an investment can go down as well as up and you may not get back the full amount you invested.

Company cars

If you drive a company car and your employer pays you for your business mileage fuel, there is some good news: most of the advisory mileage rates increased from 1 July, reflecting increased fuel costs. If you do not have a company car, but are a member of an employee car ownership scheme, there is some possible bad news: HMRC is examining such schemes to see whether they should be taxed.

Inflation up

Inflation has been creeping up over the last year. In August 2005, inflation as measured by the retail prices index (RPI) was 2.8%. The August 2006 figure was 3.4%. At that rate, if you are higher rate taxpayer, you need to be earning 5.67% gross on your deposits just to maintain your buying power.

REITs start

A new form of commercial property investment fund, real estate investment trusts (REITs), will start to appear from 1 January 2007. REITs will have tax advantages compared to some other property investment routes, but there are drawbacks. If you wish to invest in bricks and mortar, please ask us to explain all your options.