FINANCIAL FOCUS

KEEPING YOU UP TO DATE WITH DEVELOPMENTS IN FINANCIAL PLANNING

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Rob Sandwith, Chief Executive

Welcome to the spring edition of our newsletter.

As we approach another financial year-end, Mr Brown finds his finances looking more precarious and the upcoming budget will almost certainly reveal further tax raising provisions.

The about-turn announced at the end of last year on the ability to include residential property in pensions post A-Day was a staggering revelation to both pension providers and individuals, who had spent many months and significant money on implementing systems and planning for the new rules. For those investors hoping to gain property exposure through their pension funds, all is not lost! The implementation of REITS from next year will allow exposure with less risk than direct ownership.

Given the increasing impact of taxation each year, it is worth ensuring that all our clients have fully utilised their available allowances. It is still possible between now and April 6th to make investments that for those clients earning up to approximately £300,000 per annum will result in their tax bills being reduced to almost zero!

This newsletter also comments on the CGT provisions, which allow investors to make up to £8,500 tax-free gains this year. If this allowance is not used before April 6th, it will be lost.

Please contact us if you would like any further information on any of the articles in this letter and I wish all our readers a happy and prosperous 2006.

Last Call for 40% Tax Relief

These days there are an ever growing number of investments to choose from. However, some instantly look better than others. For example, would you like to make an investment which gives you 40% income tax relief,(even if you are a basic rate taxpayer), exemption from UK tax on any dividends, and freedom from capital gains tax on any profits?

These alluring tax incentives apply to high risk investments of up to £200,000 in newly issued shares of Venture Capital Trusts (VCTs). However, the 40% income tax relief is due to disappear on 5 April 2006.

VCTs are listed on the London Stock Exchange, but the companies they invest in are relatively small and either unlisted or listed on the Alternative Investment Market (AIM), the junior market.

You must hold your VCT shares for three years to keep your tax relief, but you should regard VCTs as a much longer term investment – at least five years and probably more. There can be high costs involved and there may not be a ready secondary market in VCTs or their underlying investments, so they could be hard to sell. You may lose some or all of the money you invest.

Tax relief gives lift to risky investments

The most attractive issues could become oversubscribed, as the end of the tax year nears. So if VCT investment interests you, please contact us as soon as possible. Remember that tax rules can change.

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Tax planning time

Now that the Christmas and New Year celebrations are behind us, the time has arrived for a review of your tax planning. This year it is particularly important to make sure everything is in place before the Budget, which generally takes place in March.

Chancellors from both parties have tended to make the first Budget of the parliamentary term their harshest. The logic is that the Budget nearest the last election is the one furthest away from the next election. In Gordon Brown's case, a £10bn 'black hole' in public finances may encourage him to push through further tax rises in addition to the increased tax on oil companies announced in December.

Before the Budget (date as yet unannounced), the areas you should consider reviewing include:

ISAs

Individual savings accounts continue to offer important tax benefits:

- Interest income from bond funds is free of all UK income tax.
- There is no additional tax charge on dividend income if you are a higher rate taxpayer.
- Any gains are free of capital gains tax.
- You have nothing to put on your tax return.

"The payments made by the government for contracting out are generally considered to be too low . . ."

The value of ISAs invested in share or bond funds can fluctuate and you might not get back a significant proportion of your investment. Past performance is not a guide to future performance and may not be repeated.

Personal Pension Contributions

If you want to cut your tax bill in 2005/06, one simple solution is to make a contribution to a personal pension. If you are a higher rate taxpayer, a personal pension contribution could also reduce your income tax payments on account for the coming tax year.

If you are self-employed or you are an employee, but not a member of an occupational pension scheme, you can normally make personal pension contributions. Even if you are a member of your employer's occupational scheme, you may still be able to pay something towards your pension in this tax year – ask us for details.

You can even make personal pension contributions of up to £2,808 (net) in 2005/06, without the need to have any earnings. You could also make the contributions of up to £2,808 (net) on behalf of your minor children, grandchildren or non-working partner. All contributions are made net of basic rate tax, so the actual amount invested in the pension plan would be £3,600 for a net contribution of £2,808.

Additional Voluntary Contributions

If you are a member of your employer's occupational pension scheme, you have two potential options:

- You can make additional voluntary contributions (AVCs) to top up your pension fund or, in some cases, you may be able to buy added years. Normally you can contribute up to 15% of your earnings (including the taxable value of fringe benefits such as the company car), less any pension contributions you have paid to the scheme over the year.

  From 6 April 2006, the new tax rules (see 'Pensions A-day Arrives') will mean that at retirement you can draw up to one quarter of your AVC fund as a tax-free lump sum. However, the rules of your AVC scheme will need to be changed to allow such a payment.

- You may be eligible to make a contribution of up to £2,808 (net) to a personal pension, as explained above.

- Remember, from 6 April the scope to make additional contributions will increase for almost everyone.

Contracting Out

If you use a personal pension to contract out of the state second pension (S2P), you should review whether to join the state scheme before the end of the tax year. The payments made by the government for contracting out are generally considered to be too low, but that does not automatically mean you should be a member of S2P. You should seek independent financial advice before making any decision.

Capital Gains Tax

The amount of capital gains you can make without paying tax in 2005/06 is £8,500. Investment market conditions were generally good in 2005, so you could use this annual exemption to bank some tax-free profits. If you do not use your exemption, it cannot be carried forward.

Remember that tax rules are subject to change.

The future of your pension

The Turner Report on pensions suddenly prompted politicians, journalists and experts to start a major debate about retirement issues, when the report was finally published in November last year.

Named after the commission's chairman Adair Turner, the report was the product of three years' work, and contains a range of ideas that could radically change both state and private pensions, including:

- There should be a National Pensions Savings Scheme. All employees who earn over £4,895 a year (in 2005 terms) would be automatically enrolled, unless they already had good enough pension arrangements or they chose to opt out within the first month of membership.

  Contributions would be set at 3% for the employer and 5% for the employee (including about 1% tax relief), based on earnings between £4,895 and £32,760 a year in current terms.

- The state second pension (S2P) should lose its link to earnings and be gradually moved onto a flat rate basis, as originally intended.

- Contracting out of S2P should be scrapped for personal pensions and money purchase occupational schemes. For final salary pension schemes, contracting out should be phased out over about 20 years.

- The right to receive the basic state pension should ultimately become based on each individual's period of residence in the UK, rather than their national insurance contributions record. In the short term, everyone over age 75 should become entitled to a full basic state pension.

- Increases to the basic state pension should be in line with rises in earnings rather than prices.

- A form of the currently very complicated pension credit system should remain, but it should be changed so that many fewer people would receive it.

- Very controversially, state pension age should increase in line with life expectancy to 66 by 2030, 67 by 2040 and 68 by 2050.

The government has promised to respond by the spring, but even before the report was published, the Chancellor made it clear he was worried about the potential costs of changing the current system. In any case the politics look difficult: voters will like the idea of higher pensions, but not the extra taxes to pay for them nor the higher pension age.

If the reforms – or some of them – happen, the start date is highly unlikely to be before 2010. The report is most definitely not a reason to put retirement planning in abeyance for the next four years. In fact the report provides one good reason for making pension contributions now.

The commission was very critical about the fact that 'a large proportion of all tax relief (over 50%) is received by the 12% of employees who pay higher rate tax'. Mr Brown may not have liked many other aspects of the report, but he might feel inspired to take action on pension tax relief.

"...voters will like the idea of higher pensions, but not the extra taxes to pay for them nor the higher pension age."

Pensions A-day arrives

The pensions world will undergo a radical change on 6 April A-Day. Pension tax simplification will take effect after several years of deliberation.

As a quick reminder, the main reforms will be:

- Today's eight different sets of rules for different types of pension arrangement will be replaced by one new set of rules that will apply to all pension schemes.
- Your pension benefits will be subject to a lifetime allowance, initially £1.5m. This will effectively set an upper limit on the value of tax-efficient pension benefits that you can have.
- The current limits on the amounts you can contribute to your pensions will disappear and instead you will have an annual allowance, initially of £215,000. Your maximum effective personal contribution to pension arrangements will normally be 100% of earnings.
- As a general rule, you may be able to draw a quarter of the value of all your pension arrangements as a tax-free lump sum.
- You will not have to buy an annuity by age 75, but you must draw any tax-free lump sum before then.
- There will be new rules restricting borrowing by pension schemes. However, following the Chancellor's unexpected change of mind announced in the Pre-Budget Report, investment in residential property and assets such as fine wine and antiques will be subject to severe tax penalties.
- The minimum age at which you can normally draw your retirement benefits will rise from 50 to 55 on 6 April 2010.

The new rules are accompanied by a raft of transitional reliefs, which will generally protect you from any tax penalty on actions taken or funds built up before A-Day. Some of these reliefs are given automatically, while others must be claimed.

Whatever pension arrangements you have – or even if you have none – simplification means that you should

arrange for a review of your retirement planning. The new rules open up many new opportunities, but also call into question some traditional ideas.

For example, if you are a private company shareholder/director, from April you might find it makes more sense to contribute to a self-invested personal pension (SIPP) rather than a small self-administered scheme (SSAS). At present the SSAS is viewed by many to be more attractive because the contribution limit is normally higher, but from A-Day this difference disappears.

Not everyone will be better off under simplification. You might find that from A-Day it will not make financial sense to contribute to a pension plan. For that reason, if no other, you should talk to us before making any pension contributions after A-Day. Ideally, talk to us now: there may still be some pre A-Day opportunities worth examining.

Incapacity and your income

Would £76.45 a week be enough to turn you into a long term malingerer?

Less than £80 a week may not sound much, but that is the current level of long term Incapacity Benefit (IB) and it is causing the government some concern. One reason is that IB has seemingly turned into a form of state early retirement benefit. Between 1979 and 2004, the number of people aged over 50 claiming IB increased to 1.3m[1] – nearly a fourfold increase.

A Welfare Reform Green Paper was published by the government in January 2006, proposing changes to IB in an effort to limit expenditure.These include a reformed IB regime that will see payments cut for claimants who do not try to prepare for, or find employment. The changes would follow on from an earlier reform to IB in 2000, which placed the focus purely on objective

medical criteria and removed issues of age and skills from the assessment.

Unless you have some income protection in place, you could be forced to rely on IB if an illness or accident were to keep you from work for a prolonged period. Even if your employer provides you with cover, you should check whether your payments would only last for a limited period.

You may be tempted to think 'it won't happen to me', but the number of people claiming IB underlines just how wrong you could be. You could even find that while you are unable to continue in your own job, the strict medical test rules mean that you cannot claim IB because you could carry out some other type of work. In contrast, claims under income protection are normally based on your inability to follow your own occupation.

If you do not have any income protection, or you have not reviewed your cover for some years, ask us now about setting the right level of protection for you. The alternative could be trying to live on under £80 a week – if you are eligible.

1. Source: www.ft.com, 19 November 2005

The forgotten virtues of capital gains

Are you missing out on a tax break that could be worth up to £3,400 a year to you? You could be, if you have concentrated your investments where they will just produce returns that are subject to income tax, rather than investments that can generate capital gains for you.

Cue for capital gains break.

The annual capital gains tax (CGT) exemption is £8,500 this tax year. In other words, you can realise capital profits of up to £8,500 with no tax to pay. What is more, you can benefit from £8,500 exemption in addition to two important CGT reliefs, taper relief and, for investments acquired before April 1998, indexation relief.

Taper relief is now starting to be really valuable for long term investment holdings. It starts as a 5% reduction in capital gain subject to tax once you have owned an investment for three years. Once you have owned the investment for at least 10 years, 40% of your gain will be free of CGT. If you owned an investment on 16 March 1998, you are credited with an extra year of taper relief, but your maximum stays at 40%.

For example, if you owned an investment on 16 March 1998, with taper relief 30% of your gain will now be tax free. If you wait until the start of the new tax year, your taper relief could increase to 35%. So in theory, by making sales either side of 6 April and taking your £8,500 exemption into account, you could realise gains totalling over £25,000 from long term investments with no tax liability.

If you are married, your husband or wife could do just the same, because you each have your own annual capital gains tax exemption. You could consider switching around investments between you because normally there is no capital gains tax on transfers between spouses.

If you want to take advantage of the favourable tax treatment of capital gains, you need to hold investments that are subject to capital gains tax. Unit trusts, open-ended investment companies (OEICs) and shares are all subject to CGT on profits (but not dividend income).

The problem with many investments that can generate capital gains is that they may involve your taking on more risk. These investments do not include the same security of capital which is afforded with a deposit account. Their value can go down as well as up and you may not get back your investment. Remember tax rules may change in the future.

At the moment there are some 'protected investment plans' which offer a return linked to a stock market index over a fixed period, with protection if the index falls – advantageous CGT rules apply to these. One major exception is National Savings & Investments, whose Guaranteed Equity Bond is subject to full income tax on any profits at maturity.

Tuition fees increase

This year marks the start of a new set of rules for student finance in England, which will affect your child – or grandchild – if they start a new course from this autumn onwards.

The only major exception will be for those who took a gap year in 2005/06 and by 1 August 2005 had a confirmed place for the 2006/07 academic year. Scotland, Wales and Northern Ireland each have different rules.

The most controversial feature of the new English regime is that higher education establishments will be able to charge tuition fees of up to £3,000 a year – compared with the 2005/06 flat rate of £1,175. It already looks certain that the £3,000 maximum will be the norm, partly because of the parlous state of most universities' finances.

Students will not be required to pay the higher tuition fees up front, which for most students will be a welcome change from the existing system. Instead, the fees will effectively be covered by a government loan, which students will have to repay through a new Graduate Contribution Scheme once they have finished their courses. They must repay this fee loan and also pay off their maintenance loan before becoming debt free. Both types of loans will be interest-free but inflation-linked.

Students will have to repay their loans at the rate of 9% of their gross earnings over £15,000 a year. For example, a graduate earning £22,000 would need to repay around £630 a year. In practice, this level of repayment might pay off little or nothing of a student's total outstanding debt – which for someone graduating in summer 2009 could easily be £20,000.

In such a case, the first £500 of repayment would merely cover the inflationary increase in the debt, assuming that inflation is 2.5% a year. Any graduate who becomes a higher rate taxpayer will suffer a marginal 'tax' rate consisting of 40% income tax, plus 1% national insurance, plus 9% loan repayment – equating to 50% of their salary.

If you want to ease the financial burden for a future student, there are several tax-efficient options available. The sooner you start, the better.

Inheritance tax net spreads

Inheritance tax (IHT) is turning into a significant money earner, according to two studies published in November 2005 by Halifax Bank and Grant Thornton, the accountants. Their findings were largely based on data from Her Majesty's Revenue & Customs (HMRC). Here are some examples of what they discovered:

- The total amount of IHT and the number of estates affected in this tax year have more than doubled since 1996/97, according to their projections.
- If the government scrapped IHT, they would need to increase basic rate income tax, NICs or VAT by 1% just to replace the lost government revenue.
- In one out of ten local authority areas, the average house price now exceeds the £275,000 starting threshold (nil rate band) for IHT for 2005/2006. Five years ago, the average price of a property exceeded the nil rate band (then £234,000) in only one out of 50 local authority areas.
- If the nil rate band had been indexed in line with property values over the last ten years, it would now be some £406,000 – nearly 50% higher than its actual value.

IHT is a tax that the Chancellor has been happy to leave largely unchanged since he first came into office. If people's personal wealth rises faster than retail prices, which is what generally happens over the years, IHT will produce more revenue each year, even when the nil rate band is inflation-linked.

As a tax IHT has several advantages for the Treasury: it is relatively easy to collect; it is usually only paid at death; the average tax payment is substantial; and HMRC have the whip hand because until they have granted probate, an estate cannot be distributed to the beneficiaries.

"IHT is one of the few taxes that has not been subject to tinkering by the Chancellor over the last nine years."

Both Grant Thornton and the Halifax called for a review of IHT, but it seems unlikely that Mr Brown will take much notice. In the 2005 Budget he set the nil rate band for three years (it will be £300,000 by 2007/08), which suggests he has no plans for reform in the short term. In fact IHT is one of the few taxes that has not been subject to tinkering by the Chancellor over the last nine years.

If your total wealth is above the nil rate band of £275,000 – or is likely to be so in the future – the clear message is not to look to parliament for any help. The way to deal with IHT is through careful planning, maximising the use of the available exemptions and reliefs. There remain a number of specialist arrangements which reduce the impact of the tax, and to date HMRC have accepted them as being within the terms of the IHT legislation. Some of these allow you to make a capital gift, but still retain the right to regular payments throughout your lifetime. Don't forget that taxation rules and levels may change.

Let us know if you would like further information on how to pass more of your money to your family and less to the Exchequer.

90 years young

How many years of retirement would you expect a man aged 65 today to enjoy?

The answer is 21 years and seven months, according to research published by the UK Actuarial Profession in September 2005 on pensioner mortality. If you guessed a lower number, then you are in good company. Medical advances and healthier lifestyles mean life expectancy has increased much faster than many people – including the actuaries – anticipated.

In 1994, a 65 year old man would have looked forward to three and a half years less retirement. Go forward ten years to 2015 and the actuaries' central estimate is that a 65 year old man will die just two months before his 90th birthday. And of course, women are expected to live even longer.

While we all welcome longer life expectancy, there are important consequences, both at a personal and a national level. For example:

- Living longer means that pensions will cost more – hence the proposal in the Turner Report for raising pension age (see 'The Future of Your Pension').
- Annuity rates will potentially only get worse (unless long term interest rates rise) because insurers will be paying out to pensioners for longer.
- If you do not build inflation protection into your pension, then your standard of living could fall a long way in the many years of retirement. For instance, over 20 years, 2.5% inflation will wipe nearly 40% off the buying power of a flat rate pension.
- Children waiting for an inheritance from their parents may find that by the time it eventually arrives, most of it has been spent, possibly on long term care. Worse still, for what funds are left, it might make more sense to skip a generation and pass them to the grandchildren. By then, they may be starting to worry about their own retirement planning!

Tying the knot?

On 5 December last year, the civil partnerships legislation came into being. This allows same sex couples to gain legal recognition of their relationship and receive the same tax (and social security benefit) treatment as married couples.

A few high profile civil partnership ceremonies have already taken place, which prompted some interesting press comment about the wisdom of tying the knot.

Staying outside of marriage/civil partnership has a number of distinct advantages. For example:

- Each partner has their own main residence capital gains tax exemption, so a couple could own two properties without worrying about capital gains tax.
- Many of the anti-avoidance tax rules are only triggered if there is a legal relationship between the parties involved. For example, the controversial rules regarding the tax treatment of shareholdings in husband and wife companies would not apply to unmarried partners.
- The end of the relationship does not involve divorce or dissolution, with all that implies about division of assets.

But there are also serious drawbacks to staying single, which many couples overlook. These include:

- You do not benefit from the inheritance tax exemption that normally applies on gifts and legacies between spouses and civil partners. High property prices (see 'Inheritance Tax Net Spreads') can mean a survivor has to move home simply to meet the inheritance tax bill.
- Capital gains tax could also apply on gifts to your partner.
- You may lose pension benefits, either because you are not treated as a widow(er) or, for state benefits, you cannot claim on the basis of your partner's contribution record.

The lack of an up-to-date (or any) will is also a trap for couples living together. The intestacy rules – which are no real substitute for a will anyway – only address legal relationships (including civil partnerships), so a surviving partner could be left with nothing.

Whether to marry or enter a civil partnership is not something that should be driven by financial considerations. However, you should not ignore them. Whatever your decision, it needs to be taken into account in your (and your partner's) financial planning.

Manager changes

The investment management industry seems to be going through a turbulent time in terms of personnel changes. Some of the leading individuals are switching between fund groups, and one of the UK's most respected fund managers, Anthony Bolton of Fidelity, is heading for retirement next year. The changes can be bad news if your funds are on the losing end, so this could be a good time to review your investments.

Diesel demise?

If you are about to choose a new company car, do not forget that the rules for diesels will change from 6 April 2006. At present, a diesel car that meets Euro IV standards (as all new diesels do) is taxed in the same way as a petrol car with the same CO_2 emissions level. For 2006/07 onwards any diesel registered since 1 January 2006 will suffer an extra 3% loading (subject to a maximum benefit value of 35% of list price).

TESSA anniversary

1 January 2006 was the 15th anniversary of the introduction of TESSAs (Tax Exempt Special Savings Accounts). TESSAs were replaced by ISAs in 1999, but you may well have reinvested your matured TESSA in what was once called a TOISA (TESSA-only ISA). With low interest rates, returns on these can be disappointing. Now is a good time to review your options.

REITs – new property investment opportunities

While the Chancellor, in his December pre-Budget report, closed down the possibility of pension schemes investing in residential property, the government heralded a new property investment opportunity – the UK real estate investment trust or REIT. When REITs come into being, probably at the start of 2007, they may turn out to be the most widely used route to investment in property.

REITs will provide investors with the opportunity to buy into the property sector without the risks of direct ownership, while avoiding the tax drawbacks that most indirect ways of buying property currently involve.

Investors will be able to buy into diversified portfolios of commercial and residential property in the form of shares in REITs. If all goes well, many existing property companies will convert to REITs, and many new REITs will be set up by financial institutions to provide opportunities for investors in areas such as residential property. This may be one of the very few ways that pension schemes will be able to invest in residential property.

So what will be the big difference between REITs and what is now available? The main attraction will be their tax efficiency, making them suitable for individual investors, and potentially ISAs, child trust funds and pension schemes.

Unlike property companies, REITs will not have to pay corporation tax on their qualifying income and gains. In return for this privilege, they will have to meet strict qualifying criteria and will probably be required to distribute at least 95% of their net profits to their investors. In some cases, it may be difficult to maintain these criteria and if they are breached, the tax benefits could be withdrawn.

Tax at 22% will be deducted at source from the gross distribution, but non-tax-paying investors such as pension schemes and ISAs should be able to reclaim this. Higher rate tax payers will have to pay a further 18% income tax on the grossed up distribution.

There will be other restrictions. In particular, the government wants REITs to be mainly used for property investment rather than development activities. REITs will be divided into tax-exempt and taxable elements, with a requirement that at least 75% of their income and assets must

relate to the ring fenced tax exempt element.

REITs will not be confined to investment in UK – althought they will have to be run as resident in UK for tax. They will be able to own property all over the world and can be quoted on most of the world's main stock markets.

The new rules are expected to be introduced in the March Budget and will be set out in detail in the Finance Act later this year. There is still scope for the rules to change, but the property industry has welcomed most aspects of the proposals. If the remaining differences are resolved, REITs will be a major new form of investment.