

# FINANCIAL FOCUS

KEEPING YOU UP TO DATE WITH DEVELOPMENTS IN FINANCIAL PLANNING

SUMMER 2006

## rosan helmsley

independent financial advice

3000 Cathedral Hill, Guildford, Surrey GU2 7YB

t 01483 24 35 24 f 01483 24 51 24 www.rosan-ifa.com Authorised and regulated by the Financial Services Authority



**Rob Sandwith, Chief Executive**

### Welcome to the summer edition of our newsletter.

Since the publication of our spring newsletter, Gordon Brown has introduced a raft of new taxation legislation through his latest budget. This continues Labour's process of raising further revenue through indirect taxes – the government now brings in almost three times more revenue through inheritance tax (IHT) than when it came to power in 1997. The extent of these latest changes to trust law and the impact on IHT were totally unexpected and have resulted in an urgent need for trustees to review trust structures. It also means that most of us who have established will trusts should reassess them.

A-Day finally arrived on the 6th April and with it many opportunities for improving retirement benefits. We will shortly be releasing a comprehensive guide to the new rules. If you would like to receive a copy, please contact Andrew Lyall on the office number or [andrew@rosan-ifa.com](mailto:andrew@rosan-ifa.com).

We have just released a much-improved version of our online valuation service for clients wishing to view portfolio valuations online. Reports include ISA, PEP, investment bond and pension valuations as well as summaries of life assurance benefits. Register for this service by contacting the office or through the web site.

I hope you find the articles in this newsletter informative. Please contact us if you require further information on any of the articles, and have a great summer.

## What you can learn from past performance

### 'What return will I get from my investment?'

A simple question, but one with no real answer. For example, even if you choose a fixed rate, fixed term deposit, your overall return could be affected by changes in tax and inflation levels.

Away from deposits, the value of investments in shares or bonds can fluctuate – as has happened since 2000 – and you might not get back a significant proportion of your investment. However, you should place no reliance on the past: as the advertisements say, past performance is not an indication of future performance and may not be repeated.

Nevertheless, investment experts still look at the past. For example, Barclays Capital Equity Gilt Study for 2006 shows that over the last 10, 20 and 30 years to December 2005, UK shares beat deposits based on pre-tax returns. However, in the last ten years, gilts and 15-year corporate bonds beat UK equities. Over the last five years UK shares were the worst performer.

These statistics give historical justification for investment



diversification. As the data show, no one category always comes top. The investor who chose a long term mix of cash, bonds and equities will generally have had a smoother ride than the pure equity investor and usually have beaten cash returns.

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## Where there's a will... there's a need to review it now

Many thousands of people may need to revisit their wills and inheritance tax plans following the surprise tax changes announced in this year's Budget. The changes introduce an inheritance tax charge on assets gifted into most kinds of trust, affecting both new gifts and many existing arrangements. For most people the impact is likely to be very little, but if you have a large estate, the consequences could turn out to be considerable.

The new rules only affect trusts. These are basically legal devices that allow you to make gifts for the benefit of your children or other beneficiaries, but the assets would be held by the trustees you choose.

In effect, the Finance Bill 2006 rewrites the inheritance tax rules for the two most popular forms of trusts used in estate and other financial planning arrangements: flexible trusts (which are a form of 'interest in possession' trusts) and accumulation and maintenance trusts.

The effect of the proposed new rules is that almost all new gifts into trusts could suffer inheritance tax at 20% of their value to the extent that they exceed the donor's unused nil rate band – which could be up to £285,000 this year.

Then there will be a tax charge of up to 6% of the trust's value every ten years, usually to the extent that assets in trust are worth more than the nil rate band. And there will be a proportionate charge when assets leave the trust.

Most trusts are below the nil rate band or not much above it, so there will be little or no ten yearly or proportionate tax charges. But the extra layer of complexity and the long-term impact on larger trusts could be significant.

Right now there is considerable uncertainty about the full effect of the draft legislation on new and existing trusts. There could still be

some changes in response to the widespread criticism which the measure has provoked. Remember that the Financial Services Authority does not regulate will writing and taxation and trust advice. But even now, three things are clear:

- The government is adopting an ever harder line on inheritance tax, which is expected to raise £3.6bn in 2006/07. The adjustments made to the nil rate band – which do little more than counter inflation – suggest that the subject of reform has been kicked into the long grass until after the next election.
- If you have any existing inheritance tax planning in place (including your will), it ought to be reviewed as soon as possible once the dust has settled. It may turn out that nothing needs to be altered, but only a thorough review will reveal the right course of action.
- If your estate is worth, or is likely to become worth, more than the nil rate band, and you have not undertaken any inheritance tax planning, you need to act. Once again, the timing for review will depend on the finalisation of the legislation.

Despite the uncertainty, inheritance tax planning will still be very worthwhile. A range of powerful strategies remain to ensure that as much as possible of your estate will stay in your family after our death.

“...the Finance Bill 2006 rewrites the inheritance tax rules for the two most popular forms of trusts used in estate and other financial planning arrangements...”

# The new pension investment rules – the liberation effect

Pensions have been hugely liberated by the new rules that came in on A-day – 6 April this year – making self-invested personal pensions (SIPPs) the vehicle of choice for many investors.

SIPPs have become even more attractive than they were in the past because you can generally invest far more into them each year and scope for investment is wider. These plans are not right for everyone. It is important to make sure you choose the right kind of SIPP and it is therefore essential to get competent and unbiased advice.

Her Majesty's Revenue & Customs (HMRC) has published detailed draft new rules on how you can invest your pension fund. If there are no further changes, the position (retrospective to 6 April 2006) will be as follows:

- Investing directly in residential property will generally be subject to penal taxation. However, it will be possible to make indirect investments in residential property tax-efficiently via real estate investment trusts (REITs), when these become available next year.
- Your self-invested pension scheme will be able to borrow up to 50% of the net value of the fund for any purpose. The old rules restricted self-invested personal pension

borrowing purely to the financing of commercial property purchase.

Virtually all pension providers have radically revised their pension offerings to take account of these investment revisions and the many other changes introduced on A-day. The new generation of self-invested pensions offers you a very wide investment choice, with much greater scope for contributions than was possible under the old rules.



**“Virtually all pension providers have radically revised their pension offerings to take account of these investment revisions...”**

## What if...?

**What would happen to your business if one of the key people were suddenly removed from the scene? Accidents or sudden illnesses are not predictable, and if they happen, they can have a devastating effect.**

For example, you could find that:

- Customers lose confidence and sales fall;
- Suppliers tighten their credit terms;
- The bank takes a fresh look at your overdraft and other finance facilities; and
- Staff become demotivated and leave.

The best solution in such circumstances is to replace the missing key person as soon as possible. However, if you have tried to recruit senior staff recently, you will know that this is easier said than done. It is also a costly exercise, both in terms of management time and headhunting fees.

One way to prepare your business for this type of disaster is to arrange life and health insurance on your key personnel. Then, if the worst happens, your business would at least have access to funds to bridge the period until your replacement for the key person is up to speed.

Unfortunately, key person cover is often the forgotten part of a business's insurance portfolio: the key person's desk and office building they sit in are insured, but not the most difficult item to replace – the individual who occupies them.

# Cover with added tax relief...

The Chancellor has potentially cut the cost of new life cover at a stroke by allowing full tax relief on the premiums. So you could benefit from a discount of up to 40% (22% if you are a basic rate taxpayer) on the cost of certain kinds of life cover.



## A brighter option for life cover.

What has happened is not quite as strange as it may at first seem. The change in the tax rules only applies to term assurance cover taken out under pension plan rules. You can take out this type of cover separately from your pension retirement savings plan. Tax relief does not apply to ordinary life cover.

There has been full income tax relief on premiums to pension term assurance (PTA) policies for a long time. But until this April, the rules were very restrictive and it was typically not a viable option for most people. Since A-day, all that has changed.

The amount of cover you can now arrange under pension plan rules is huge. Under the new rules, your pension arrangements can, in total, provide a lump sum on death of up to £1,500,000 – that is, the amount of the standard lifetime allowance in 2006/07 – and it will be more in later years. This possibility ceases when you reach the age of 75 and there are different rules for the death benefits of pension

arrangements where you have started to draw the retirement benefits.

What is more, the amount you can spend on pension term assurance has increased very substantially. Your overall maximum tax-relievable personal contribution to all pension arrangements is normally 100% of your earnings. So you could be contributing as much as half or more of your earnings each year to your retirement pension and still be allowed to pay tax relievable premiums for your life cover.

Even if you have no earnings whatsoever, you can contribute up to £3,600 a year before tax relief and get at least 22% tax relief. If you are not saving for retirement, the whole of your contribution can be used for life cover.

These two limits will probably mean that you have scope to use PTA to increase your life cover significantly. You could also replace your existing life assurance policies with PTA, thereby gaining income tax relief on premiums.

This substitution option has obvious appeal and has even attracted some direct mail advertising. However, it needs to be handled with some care. It is not a simple question of cancelling your old life policies and then filling out the form for a new PTA policy:

- You should never cancel any cover until the new cover is in place. If you do, you could leave your family exposed during a period when you have no life cover. Worse still, you might find the terms of your new cover are less attractive than its predecessor.
- PTA cannot run beyond age 75, so it is of limited value for long-term inheritance tax cover, although it can be useful for covering the temporary liability on lifetime gifts.
- The PTA rules mean that the cover provided is basic. For example, many life term policies incorporate a terminal illness benefit, which means the policy pays out if you are diagnosed as having less than one year to live. PTA does not include this.
- The very few people who have accrued substantial retirement benefits and have or will preserve them under the special A-day transitional reliefs should not take out this type of cover. This is just another reason why it makes sense to get advice – even about something as apparently straightforward as life assurance cover.
- The premium savings may not turn out to be as great as you expect. For a variety of reasons, the PTA premiums before tax relief may be higher than your current premiums. The overall saving could therefore be small, particularly if you are a basic rate taxpayer. It is also worth bearing in mind that the tax rules could change again at some point in the future.

Life cover is one of the basic financial planning building blocks for most people. The opportunity to buy this essential insurance product with the benefit of tax relief is very good news. It makes sense to review your life assurance needs and solutions now.

# Retirement income options now

If you are due to retire shortly, you should be among the first to benefit from the new rules for pension income benefits introduced on 6 April 2006. So if you are a member of an executive pension plan, personal pension plan or retirement annuity, you have three main options.

## ■ Purchase an annuity

Rates may be at historically low levels, but annuities should not be dismissed without careful thought. The traditional annuity has one very important advantage: it will give you a guaranteed gross income for as long as you live. While the alternatives can offer you potentially more income, they do not normally have any guarantees: income could fall as well as rise.

If you choose a traditional annuity, you should never accept what your pension provider offers without first checking with us what annuity rates are available in the marketplace. Many life companies do not compete for annuity business and only quote annuity rates because they have to. The difference between the best and worst rates in the market can be very substantial.

There are also now a small number of investment linked annuities. With these, you choose an assumed return for the investments underlying the annuity (between 0% and 5%) and this determines your initial level of income. Your subsequent income will depend on how the investments perform in relation to that assumption.

If you are relatively cautious about how fast you think the underlying investments will grow in the future, you will start off with a low income, but with a higher probability that it will grow in the long term. But if you are reasonably optimistic in your assumptions, your initial income could be higher, with the possible danger that it will not increase and may even fall in the future.

## ■ Pension fund withdrawal

Your income is provided by making regular withdrawals from your pension fund (sometimes also called income drawdown or, under the new pension regime, unsecured income). The new tax rules mean that you are no longer required to buy an annuity by age 75 if you choose pension fund withdrawal. Instead you can continue withdrawals as unsecured

income in the more restrictive form of an alternatively secured pension (ASP).

Up to age 75, pension fund withdrawals can be varied from nothing to about 120% of the current level annuity rate for your age and sex. The nil withdrawal option can be particularly useful if you want to draw your tax-free cash immediately but defer receiving any income (or buying an annuity).

If you were to die before reaching the age of 75, the remaining withdrawal fund can generally be paid to your beneficiaries free of inheritance tax. If you opt for ASP at age 75, there are no lump sum death benefits, other than the option of a tax-free payment to your nominated charity.

If you have dependants, in the first instance your remaining fund must be used to provide income benefits for them. If you have no dependants (or on their subsequent death) the residual fund can be transferred to the fund of another member of your pension scheme (eg

a grandchild), but this would be liable to inheritance tax.

## ■ Phased retirement

If you do need your tax-free cash for a specific purpose, eg repaying loans, you could consider phased retirement. Under this option, each year (up until age 75 at the latest), you use part of your pension fund to provide:

- a tax-free lump sum, and
- either buy an annuity or take a pension fund withdrawal.

Your retirement 'income' is the combination of the lump sum and the taxable annuity or withdrawal payments. Normally this process means that there is little income tax liability in the early years, as most of your 'income' is actually in the form of tax-free cash.

You should only consider phased retirement, pension fund withdrawals (including ASP) or investment linked annuities if you can afford to see your retirement income fluctuate. For example you might have another major source of income.

The options set out above are for information only. You should take independent advice before taking any action.



# Why not employ your partner?

“If you are a self-employed higher rate taxpayer, your joint total savings could be £2,061...”



If you are in business on your own account, employing your spouse or partner can be a highly tax-efficient way of using some of your profits. Indeed, the government has almost gone out of its way to encourage this type of family employment.

Your new employee's pay will be allowable against your business profits, provided the employment is genuine and the salary justifiable. So you save income tax and national insurance contributions (NICs) – a total reduction of up to 41% of pay.

Your special employee's pay is treated as their personal earnings for tax purposes, which might mean it escapes liability altogether, if the level is low enough.

For example, if you gave your family employee a salary of £5,028 a year (£419 a month), neither of you would normally have any NICs to pay on this wage, because the NICs starting point is just £420 a month. If your employee had no other earnings, their salary would be covered by their personal allowance (£5,035 in 2006/07) and so would be free of tax.

If you are a self-employed higher rate taxpayer, your joint total savings could be £2,061, as shown below in the table.

The benefits do not end there, thanks to the government's wish to see adequate pension provision for the lowly paid:

- Provided your employee is under state pension age, they will receive credits for the basic state pension and earn benefits under the State Second Pension Scheme (S2P), even though no NICs will be paid. A year's membership of S2P is currently worth at least £66 a year in index-linked pension from state pension age.
- You can add a pension plan to your employee's remuneration package and receive full tax relief on the contributions (and reduce your NICs bill further). In theory, under the new pensions regime, you *could* contribute up to the annual allowance of £215,000, but such generosity is highly unlikely to be agreed by your tax inspector. It is much wiser to make a modest contribution. In the past, the chosen figure has been £3,600, the normal tax relievable personal contribution limit for non-earners. At this level, your tax inspector should usually have no concerns.

Similar benefits are available if you operate through a company rather than on a self-employed basis. In an environment where there are increasing constraints on tax planning, employing your spouse or partner is one option you should not miss.

Profit/salary paid to:	Self £	Employee £
Profit/salary	5,028	5,028
Less: Income tax @ 40%/0%	(2,011)	Nil
National Insurance @ 1%/0%	(50)	Nil
<b>Net Income</b>	<b>2,967</b>	<b>5,028</b>

# Cut with a sour aftertaste

A number of banks and building societies have been quietly cutting their deposit interest rates, even though the last reduction in the Bank of England base rate was in August 2005. These cuts, which are sometimes justified as a response to market conditions, could well be followed by further reductions should the Bank nudge the base rate down later in the year.

With interest rates at relatively low levels, a seemingly small snip of 0.2% from the rate can add up to a painful cut in your overall interest income. But the other result is a correspondingly useful increase in profit margins for the bank or building society, so you should not expect the trend to be reversed.

If you depend on your investment income, there are still some attractive income investments around, provided you are willing to look beyond short-term deposits. However, unlike deposits, which are secure, the value of shares and other investments can fluctuate and it is possible you might not get back a significant proportion of your original investment. Past performance is not a guide to future performance and may not be repeated.

Below are some options for current income-oriented investments, but they are for information only and you should take independent advice before taking any action.

- **UK equity income funds** Although the value of UK shares has been rising for some time, their income yield remains attractive relative to deposit rates. Investment in UK equity income funds can offer you a good income now with potential for long term growth both in your income and capital values. However, as with any share-based investment, income and capital values could fall.
- **Overseas equity income funds** A handful of income funds investing in overseas markets have recently been launched. These can provide you with some worthwhile

diversification alongside the large number of UK equity income funds. Exchange rates may cause the value of these funds and the income from them to fluctuate.

- **Corporate bond funds** Yields on corporate bonds have changed little over the last year. As a result, many corporate bond funds still offer higher income yields than deposit accounts – yields that do not change in response to moves in base rates. But do not forget that your capital is at risk in corporate bond funds. One important tax advantage of these funds is that you can invest in them via ISAs and PEPs, which means you receive your fund income free of UK tax. Remember tax rules can change in the future.
- **Guaranteed income bonds** If you are a higher rate taxpayer and are prepared to accept little or no access to your capital during the fixed term of several years, guaranteed income bonds can be worth considering. These can provide monthly or annual payments, but under the current tax rules all your income tax liability will generally be postponed until the date the bond matures.

At that point, if you are a higher rate taxpayer you only pay additional tax (at 20%) on the total net overall return – the total amount you have got back including the monthly/annual regular payments less the amount you invested. With a deposit account, your extra tax is based on the gross interest.

“...there are still some attractive income investments around, provided you are willing to look beyond short-term deposits.”



## Time for a with profits reassessment?

The strong stockmarket performance of 2005 meant that in the early months of this year, some life companies reduced the market value reduction factors for their with profits policies (and hence increased surrender values), even if they did not increase bonus rates. As a result, now is a good time to review whether to keep the policies or reinvest elsewhere.

## Beware the A-day bulletin

Have you received a bulletin from your pension providers about A-day changes? If it doesn't make much sense – and some of them are far from comprehensible – we can translate the pension speak into plain English. Don't just ignore it as more red tape – the changes that are being made could alter your retirement plans.

## Lower pension projections

If you have a personal pension or are a member of a money purchase scheme, you will normally receive a statutory projection of your retirement benefits each year. Do not be surprised if this year's projection is lower than last year's. The annuity basis has been changed to reflect a fall in the return on inflation-linked bonds to a near all-time low.

# The next steps on trust tax changes

**The surprise inheritance tax changes (see 'Where there's a will, there's a need to review it now') were not the only amendments which the Budget made to the tax treatment of trusts. The Chancellor also announced a range of largely technical measures aimed at 'modernising the tax system for trusts'.**

Some of the changes made good sense: there was no logic in having different definitions for income tax and capital gains tax purposes of certain key words related to trust taxation. The doubling of the trust's standard rate band for income to £1,000 was also welcome. However, this was not quite as generous as it seemed because the band is now spread across all trusts created by the same person, subject to a minimum of £200 per trust.

There was another change which, while not unexpected, was not helpful. If you set up a trust for your minor children, then until the age of 18 (or their earlier marriage) any capital gains tax liability on the trust's investment will fall on you – not, as was the case before 6 April 2006, the trustees or, for bare trusts, the child. This ruling applies to all existing trusts and has some unfortunate consequences.

For example, it means that if you invested in OEICs or unit trusts via a designated account for your minor child, any capital gains tax liability falls on you if the holding is sold (or switched) before your child reaches age 18 (or marries). Fortunately this new rule does not extend beyond parental gifts, so gifts into trust from, for example, grandparents are unaffected.

The changes that have been made to trust taxation in recent years have removed virtually all of the tax advantages which trusts once enjoyed. For example, trusts now generally pay the same rates of tax on income and capital gains as a higher rate taxpayer. With the new inheritance tax rules, there will be many



circumstances where a trust's total tax burden is higher than an individual's would be. While the proposed changes are not yet definitive, they will raise some difficult issues for trustees.

If you are a trustee of any non-charitable trust, then your next trustees' meeting needs to have on its agenda the question of whether it makes sense to continue the trust. In some instances the beneficiaries will be better off if the trust is wound up and its assets distributed.

In other cases, the tax cost of winding up, the age of the beneficiaries or some other reason may mean the only sensible option is to continue with the trust. If that is the case – and often it will be – then you and your fellow trustees should take advice on the most tax-efficient way of holding the trust's investments.

**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 May 2006.