FINANCIAL FOCUS

KEEPING YOU UP TO DATE WITH DEVELOPMENTS IN FINANCIAL PLANNING

AUTUMN 2007

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Rob Sandwith, Chief Executive

Welcome. The projections made in the last two newsletters regarding stock market volatility have certainly proved prophetic. The Northern Rock situation reminds us all that individual share price movements can be very dramatic, even for FTSE 100 companies, with Northern Rock falling over 55% in two trading sessions.

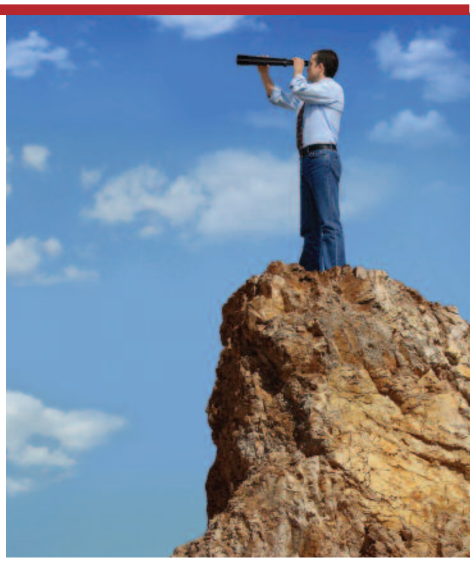
Inevitably, these periods of volatility offer long-term investors an opportunity to enter the market or top up investments. We would certainly encourage pension and SIPP investors to make their investments now rather than wait for the usual last minute run-up to 5 April.

Remember that pension investments can be committed to cash ahead of making investments into financial assets. Of course interest earned from cash on deposit in a SIPP or pension is better than earned in a current account as it is paid gross. This year it is possible for all individuals who have the relevant income to invest up to £225,000 into a pension at a cost after tax relief of only £135,000 – an extremely generous concession.

Starting a pension fund for a child or grandchild can form the basis of a great IHT plan and give young adults a solid start to their financial life. An annual investment of £3,600 invested from birth to age 21 will provide a pension fund of a little over £152,000 at age 21, assuming 6% per annum returns.

Taking the long view

'The value of investments can go down as well as up.' How often have you read those words? The answer is probably many times: the statement has been almost obligatory on any piece of investment advertising for almost the last 20 years.



Even so, when investment values do fall – as they did this summer – many people seem surprised, shocked or even horrified. If you find yourself in any of those categories, it pays to step back and view events with a longer-term perspective:

- Investment markets have enjoyed very favourable conditions since Spring 2003, when the second Gulf War started. For instance, the FTSE™ 100 Index hit a low of 3,287 in March 2003[1] and had risen almost in a straight line until July 2007.
- Making changes to long-term investments in response to short-term market movements could seriously harm your overall returns. Investment values can rise just as sharply and suddenly as they fell in July and August. Over the last 15 years to the end of 2006, missing just the best 20 days of UK stock market performance would have more than halved overall returns, according to one major investment house.[2]

'Sitting tight' can be hard to do when the news headlines suggest that Armageddon is imminent. In such circumstances it is worth remembering a rearrangement of the warning words with which we started: the value of investments can go *up* as well as down.

1. *www.digitallook.com, 10 September 2007.*
2. *Fidelity UK, 'When Doing Nothing is Best', 31 July 2007.*

in this edition. . .

Coming to the pensions crossroad

How you draw income from your pension plan is one of the most crucial choices you can make about your retirement. The difference between making the right and wrong decision can be the difference between a comfortable retirement and 'getting by'.

There is now a wide range of options, thanks partly to the pension tax changes introduced in April 2006. In practice, two routes are dominant: annuities and income drawdown.

Annuities The pension annuity is the traditional way of converting a pension fund into a regular income. It has the great virtue of providing payments throughout your life – however long that may be. These payments are guaranteed, unless you choose an investment-linked annuity.

The annuity market is fiercely competitive, but its elements can vary from those in the pension plan market. A good pension plan provider may only offer poor annuity rates, making it very important that you do not accept what your provider offers without first checking with us what is available elsewhere. Industry figures suggest that by shopping around you may be able to improve your pension by as much as 30%.[1]

"...it is very important that you do not accept what your provider offers without first checking with us what is available elsewhere..."

There have been a number of innovations in the annuity market over recent years, one of the most significant being the spread of enhanced annuities. These may offer you higher rates if your health or lifestyle is less than 100% perfect. For example, if you are a smoker or have diabetes, you could qualify for a better annuity rate.

Income Drawdown Income drawdown, a form of unsecured income, is generally a higher risk strategy than buying an annuity and on the whole is only suitable for those with a range of other sources of retirement income.

As the name suggests, under income drawdown your retirement income consists of taking withdrawals – regular or one-off – from your pension fund. HM Revenue & Customs (HMRC) sets a maximum withdrawal level and requires that withdrawals stop by age 75, at which point you must either buy an annuity or switch to an 'alternatively secured pension'.

Income withdrawals have some advantages over annuities to set against the greater risk:

- If you die before age 75, the value of your remaining fund could be paid out as a lump sum. This is subject to a 35% income tax charge, but normally inheritance tax will not apply. Alternatively, the full value of the fund could be used to provide an income for your dependants.
- You could vary the withdrawals you take each year from nothing to about 120% of what a standard annuity would give you.
- You do not have to make up-front decisions about dependants' benefits. In contrast, if you make the annuity choice, you have to buy the dependants' benefits at the time you set up the annuity.
- You could continue to control where your money is invested and you are not tied to the fixed interest investments that underpin traditional annuities.

Some income drawdown providers now offer an income guarantee, which has created an interesting halfway house between the annuity and full risk income drawdown.

But all this extra flexibility and control comes at a price. Running an income withdrawal arrangement costs more. In particular, it involves more risk because the value of your investments can go down as well as up. As a result, the income may turn out to be lower than a comparable annuity, especially as, unlike annuities, there is no cross subsidy from people who die prematurely to those who live longer than average. If you start drawing a high income, it might not be sustainable if the investments do not perform. What is more, you could end up regretting not buying an annuity earlier if the rates continue to become more expensive.

So there are pros and cons to both annuities and income withdrawal. Our role is to help you decide on the most appropriate route for you.

1. HM Treasury, 'The Annuities Market,' December 2006.

Year end choices for company directors

The last day of the year, 31 December, is a popular date for company year ends. This year it falls on a Monday, although many companies may be drawing a line in the accounts on the previous Friday, rather than opening on New Year's Eve.

If your company has a 31 December accounting date, you need to start thinking about your year end corporate planning now. December's festive activities could all too easily get in the way if you delay until nearer the deadline.

You have three main options in terms of drawing out profits: dividend, bonus and pension contribution. In 2007, there have been subtle changes on all three fronts:

- **Dividends** The small companies' rate of corporation tax increased to 20% on 1 April 2007, so if that rate applies to your company, its effective tax rate for calendar year 2007 will be 19.75% (a quarter of the year at 19% and three-quarters of the year at 20%). The small companies' rate rises to 21% for 2008 and 22% for 2009.

- **Bonuses** HM Revenue & Customs (HMRC) has issued new guidance on the level of remuneration for controlling directors that they regard as allowable against tax. They say that '...the level of the remuneration package is a commercial decision and it is unlikely that there will be a non-business purpose for the level of the remuneration package'. Dividends do not count as remuneration.

- **Pension contributions** The guidance on controlling directors' remuneration also applies to pension contributions, which *do* count as part of remuneration in HMRC's view. The maximum total contributions that could normally be made on behalf of a director without attracting a personal tax charge (the annual allowance) has risen to £225,000 for 2007/08.

The choice between whether you draw a bonus or dividend still works out in favour of dividend if your company's profits are subject to the small companies' tax rate – see table below.

Bonus v Dividend	**Bonus £**	**Dividend £**
Marginal gross profit	50,000	50,000
Corporation tax	N/A	(9,875)
Dividend	N/A	40,125
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)	(10,031)
Net benefit to director	26,153	30,094

Assumptions:

- Company's marginal corporation tax rate is 19.75% for calendar year 2007.
- Director's marginal income tax rate is 40% (32.5% for dividends less 10% tax credit).

While dividends win if you need the cash, pension contributions may remain the way of avoiding any immediate charge to tax or NICs. The Financial Services Authority does not regulate taxation advice.

Investor protection facts

'In view of recent events in the banking sector, what are my legal rights if my bank or other provider cannot meet its obligations?'

Investor protection is mainly provided by the government's Financial Services Compensation Scheme. How much you get depends on the type of investment.

- **UK Bank and building society deposits,** following the run on the Northern Rock, are now covered up to £35,000. Until the recent change in the rules, the maximum pay-out was £31,700 for deposits of £35,000 or more. The Chancellor Alistair Darling has suggested that these limits will almost certainly rise considerably higher.[1]

- **UK Investment products**, such as unit trusts or OEICs, that were sold after 27 August 1988 are 100% covered for the first £30,000 and 90% covered for the next £20,000, making the maximum pay-out of £48,000 on £50,000 of investments.

- **UK Life assurance policies** are covered for 100% of the first £2,000 and 90% thereafter, with no cash ceiling, although the 90% figure could be cut back if an independent actuary considered the original benefits were excessive.

1. Speech by Chancellor of the Exchequer, the Rt. Hon. Alistair Darling MP, 1 October 2007.

Don't forget about estate planning

Did you set up a trust before 22 March 2006? If so, it may well have been affected by inheritance tax (IHT) changes introduced in last year's Budget.

At the time, the Chancellor's proposals created considerable controversy, not least because they went unmentioned in his Budget speech. Mr Brown's original ideas were tempered after much lobbying, and one of many consequences was a set of special transitional rules that apply until 5 April 2008. These apply primarily to power of appointment trusts, often called flexible trusts, and accumulation and maintenance (A&M) trusts.

In the case of power of appointment trusts, you should review the existing beneficiaries and make any changes before 6 April 2008 to avoid being caught by the new rules. For A&M trusts, you need to decide whether to vary the age at which capital and income entitlements begin, probably bringing them together. If the beneficiaries do not become fully entitled to all of the trust's assets by age 18, there could be subsequent IHT charges.

While the Government has made life harder for trusts, it has eased the burden for some married couples and civil partners. The Chancellor announced in the October Pre-Budget Report that the nil rate band, currently £300,000, would become transferable between spouses and civil partners.

So, for example, if you die first and leave everything to your spouse, their nil rate band will be doubled. This is good news if you are unable – or unwilling – to pass assets away from your spouse on first death. However, if you have built first death bequests into your will to make use of the nil rate band, the latest changes may make little difference to your joint IHT liability.

Amidst a great deal of recent speculation about IHT in the political arena, it may be tempting to give up IHT planning in the hope that the issue will disappear. But that is not a very safe approach to the problem and as a general rule, the earlier you start planning, the better. The Financial Services Authority does not regulate taxation and trust advice.

Storm subsides on commercial property funds

Until very recently, according to the Investment Management Association, property funds were the most popular sector for unit trust and open-ended investment company (OEIC) investors. Then in July 2007, a sudden squall hit.

Funds investing directly in commercial property experienced a net outflow of cash, and this forced them to change the valuation basis on which their fund prices were calculated. The falls in fund prices prompted some 'Shock! Horror!' headlines in parts of the press, with suggestions that small investors had been sucked in at the top of the market.

If you have invested in property funds recently, and have been worried by some of what you read this summer, you may take comfort from the following:

- After a very strong performance over the past few years, the property market is now cooling down, but in our opinion it is not crashing.
- The case for including commercial property in a balanced investment portfolio remains sound. As if to underline the point, in June 2007 the Association of Private Client Investment Managers added a 5% commercial property element to its three model private client portfolios.
- Some funds are now once again experiencing net inflows from investors and their prices have risen to reflect this. Perhaps predictably, the press has not made banner headlines of 5% fund price increases.[1]
- Directly invested property funds are generally much less volatile than their equity counterparts. The turmoil in world stock markets during July and August of this year were a timely reminder of this.
- If you have Individual Savings Accounts (ISAs) or Personal Equity Plans (PEPs) linked to directly invested property funds, you may well benefit from a tax change proposed by the Government and due to be introduced next April. The net effect of this could be to remove the 20% non-reclaimable tax which currently applies to the fund's rental income.

Commercial property is not a get-rich-quick, short term investment and you should not treat funds which invest in it as such. If nothing else, the 4% stamp duty that applies to virtually all commercial property transactions is a serious obstacle to speculative profits. The role of commercial property is, like shares, that of a long term investment which can potentially generate both capital gains and a rising income.

The value of property investments and the income from them can fall as well as rise and you may not get back the full amount you invested. Past performance is not a reliable indicator of future results. Property is a specialist sector and can be volatile in adverse market conditions and there could be delays in realising the investment. The value of a property is generally a matter of a valuer's opinion rather than fact. Tax treatment depends on your individual circumstances and may be subject to change in the future.

1. www.trustnet.co.uk, September 2007.

Protecting your income against ill health

Protecting your earnings against being unable to work because of ill health or injury should be a high priority for almost anyone of working age.

According to research produced in 2007 by Munich Re,[1] the chances of being unable to work for a period of at least six months because of illness or injury during one's working life are one in five for women and one in six for men.

Of course, the welfare state does provide for you to a certain extent and there are a number of benefits available depending on circumstances. For example, one core benefit that kicks in after the first year of incapacity (during which payments are lower) currently pays out £81.35 a week. There are other benefits that could be added to this, but you might seriously struggle on state benefits alone.

A fortunate few enjoy protection against the financial consequences of ill health through their employers. But check carefully. Many people think their employers have a scheme that means they will continue to pay their sick employees' salaries until they retire. But when they look at the detail, they usually discover that the provisions of the scheme simply undertake to pay their salary for six months or so.

You may also assume you have adequate cover that you took out with your mortgage. However, many of these policies pay out if you are ill for a maximum of one year only – which does not cover the very real chance of long term disability.

By contrast, with an income protection policy, you can receive a tax-free income of up to around half your earnings if you cannot work because of long term health problems. The premiums may be less than you think, especially if you can choose a policy that only starts paying out after six months from the date of the incapacity and if you are relatively young, healthy and work in an office or similar occupation.

You do not only have to be at work for income protection to be a very necessary form of insurance cover. According to Legal & General's 2006 'Value of a Mum' survey,[2] replacing a mother's work around the home is likely to cost almost £24,500 a year. In many cases, the cost of hiring a nanny and other forms of home help if a non-working partner falls seriously ill could easily exceed this figure.

We can take a hard look at the small print of any policies to choose the most appropriate for you – the terms of these plans vary, so it makes sense to buy this type of cover with the assistance of professional advice.

1. Munich Re for Bright Grey, July 2007.
2. Legal and General 'Value of a Mum' survey, March 2006.

How to help to reduce student debt

Despite a small percentage fall in graduate debt this year, the average student now owes £11,123 on graduation, compared with only £5,096 ten years ago, according to research by uSwitch.com.[1]

With higher tuition fees for 2007/08 and inflation that still nudges an annual 4% – as measured by the Retail Prices Index (RPI)[2] – it seems all too likely that the long-term trend of growing student debt will continue.

Parents and families should bear in mind that the days of free higher education for most students are almost certainly over. The annual university tuition fees are currently up to £3,070 and are normally financed through special student loans. Indeed, costs may well rise a lot further in the future. The actual cost of the courses is often many times this figure, especially in medicine, the sciences and practical degrees. There is already pressure from a number of universities to increase the fees ceiling.

So if you expect that your child or grandchild could go to university or college, you should think about creating a special fund to help them through these years. Students who are not forced to work during the term time to finance themselves can find it much easier to study effectively and get a good deal more out of their course.

There are several excellent options for building up a tax-efficient fund for a student-to-be. The right one for you and your family will depend on circumstances. For the long term, ISAs, child trust funds and even offshore bonds could play a part, while fixed rate deposit accounts and guaranteed growth bonds may be more appropriate if college days begin soon.

Students with good parental support are often those with the lowest debts. But they can also help themselves by:

- Investigating the chance to obtain a student loan via the Student Loans Company (www.slc.co.uk). It is generally the best value long term borrowing.
- Working during the vacation and possibly also taking a part-time job (of no more than 15 hours a week) during the term time, as long as it doesn't affect their studies.
- Drawing up a detailed budgeting plan at the start of each term and sticking to it.
- Making sure they have a student bank account with an interest-free overdraft.
- Finding out about university help with student fees, as well as the Students Union hardship fund.

1. uSwitch.com, August 2007.
2. National Statistics, August 2007.

Changes ahead on ISAs and PEPs

Shortly before Parliament rose for its long summer recess, it passed regulations that will revamp personal equity plans (PEPs) and individual savings accounts (ISAs) from 6 April 2008. The main changes are:

"The benefit of tax-free interest is not something to be given up lightly."

- **PEPs no more** All PEPs will become stocks and shares ISAs. Many investment groups will take the opportunity to merge any PEPs and ISAs you hold with them automatically. On the plus side, the switch from PEP to ISA rules will marginally widen your investment opportunities. On the minus side, the change will mean any cash interest you earn in the former PEP will be taxed at a flat 20%, whereas currently it is normally free of tax.

- **Contribution limit up** The overall investment limit for ISAs will rise to £7,200 a year, of which up to £3,600 may be invested in a cash ISA. Since they were first launched in April 1999, the annual contribution limit for ISAs has been £7,000, so the extra £200 is far from generous. If the limit had moved in line with price inflation, it would be nearer £8,900 by April 2008.

- **Minis and maxis disappear** The confusing distinction between mini-ISAs and maxi-ISAs will disappear. Instead there will be two types of ISA – a cash ISA and a stocks and shares ISA. You will be able to mix-and-match between the two, provided you only arrange one ISA of each type in a tax year and stay within the contribution limits. For example, you could arrange a £6,000 stocks and shares ISA with company A and a £1,200 cash ISA with company B. This will give you a little more flexibility than there is under the current rules.

- **No end of ISAs in sight** ISAs were originally intended to have a lifespan of ten years (to April 2009), subject to an interim review. The deadline was then extended and has now been scrapped completely. ISAs will therefore be a 'permanent part of the savings landscape', to quote the Treasury. This is a welcome confirmation and adds to the value of ISAs in retirement planning. However, you should remember that tax laws can still change in the future and the value of tax reliefs depends upon your individual circumstances.

- **Conversions** It will be possible to convert from a cash ISA to a stocks and shares ISA, but not the other way around. There is more than an element of 'Greeks bearing gifts' about this concession. The benefit of tax-free interest is not something to be given up lightly. It is no coincidence that the Treasury has set the investment limit for cash ISAs at half of that for stocks and shares ISAs.

Now is a sensible time to review your PEPs and ISAs, ahead of the forthcoming changes and the tax year end ISA season.

The benefits of investing offshore

Offshore investment has had some bad press in recent months, primarily because of a campaign by HM Revenue & Customs (HMRC) to encourage offshore deposit account holders to reveal any undeclared interest.

The HMRC 'Offshore Disclosure Facility' was all about tax evasion, ie illegal action designed to hide a tax liability from HMRC. Tax avoidance, ie taking legitimate action to minimise your tax bill, is something completely different. Unfortunately the press – and sometimes HMRC themselves – fail to make the distinction.

Investment offshore is not a panacea for all your tax ills, but there is a variety of circumstances where it can prove a valuable planning tool:

- **Non-domicile** You may be able to avoid UK income tax, capital gains tax and inheritance tax on offshore investments if you are not domiciled in the UK, for example you were born overseas and intend to return to your original home country in the future. The rules are labyrinthine, but can result in substantial tax savings, witness the fact that many of those who top the UK rich lists are non-domiciled.

  The Pre-Budget Report outlined a number of changes to the treatment of non-domiciled UK residents aimed at raising additional revenue. Full details are not yet available, but it appears that planning opportunities will remain, particularly for those whose stay in the UK is for less than seven years.

- **Emigration** If you are planning to live abroad, either to work or to retire, you may be able to use offshore investment to avoid tax both in the UK and in your new home country. This is a complex area of financial planning, because you will need specialist advice about the tax rules of two countries and how they interact.

- **Sidestepping tax deduction at source** If you are on the border of paying tax, it can be difficult to obtain income without tax being deducted at source. The rules that permit the payment of gross interest on UK bank and building society deposits only apply to those who can sign a declaration that they are non-taxpayers. If you cannot do this, there may be no alternative but to go through the tax reclaim process.

  You can receive income without tax deducted at source by choosing the right offshore investments. This income is still potentially taxable, a point that many people seem to have forgotten or ignored in the past – hence HMRC's campaign.

- **Deferring tax** Offshore investments can be a useful way of deferring tax. Many investments, such as offshore investment bonds, create no UK tax liability until they are realised. The tax rules can also be particularly favourable for partial realisations.

Pension age increased

If you were born after 5 April 1959, your state pension age has just been increased. The Pensions Act 2007, which became law on 26 July 2007, contains provisions that raise the state pension age to 68 by 6 April 2046.

The first increase of one year, to age 66, is being phased in between April 2024 and April 2026. The system operates by fixing a specific date for a one month band of birthdays. For example, if you were born between 6 October 1959 and 5 November 1959, you will reach state pensionable age on 6 May 2025. A similar process to increase state pension ages by a further year in each case will take place from 2034–36 and 2044–46.[1]

The tightening of the timescale for state pension age rises probably reflects the Treasury's desire to offset the increases in state pension expenditure that will come from:

- Linking increases in the basic state pension to average earnings, rather than prices, from 2012 at the earliest, which would tend to make state pensions grow faster; and

- Reducing the qualifying period for full basic pension entitlement to 30 years rather than 90% of working life from 6 April 2010, so that many more people would qualify for full state pensions.

If you are under 48, the increase in state pension age could mean that a gap has opened up between the date when you are expected to retire under your employer's pension scheme and the time when your basic state pension begins.

1. Office of Public Sector Information, September 2007.

Business tax changes on the way?

Changes to the taxation of small businesses from 2008/09 – for both companies and the self-employed – were confirmed in the Pre-Budget Report. This follows HMRC's defeat in Arctic Systems, a House of Lords case involving dividends paid to the husband and wife owners of a small IT company.

Tax return time

Your 2006/07 tax return is due in by Thursday 31 January 2008 if you want to avoid a possible fine of up to £100. If you still use paper returns next year, your 2007/08 return will need to be in by 31 October 2008 – three months earlier. Internet returns will still have a 31 January deadline.

A pension plan for Christmas?

Giving a child or grandchild a Christmas present which they cannot actually use for 40 or 50 years may not be the best way to generate instant gratitude over the festive season. But it is likely to be very much more in the child's long term interests than handing out yet another lump of plastic to be stuffed in a cupboard a couple of days later and soon forgotten.

Parents, grandparents or others who make contributions to a child's personal pension plans can take advantage of a range of valuable tax benefits:

- A contribution before 6 April 2008 of up to £2,808 will have £792 added to it by HM Revenue & Customs (HMRC) in the form of basic rate tax relief. A contribution of £2,808 will therefore instantly become worth £3,600. From 6 April 2008, the basic rate of tax is due to drop 2% to 20%, so you will then need to invest £2,880 after tax relief to contribute the same total amount of £3,600. That will still be good value even if it is an extra £72.

- The funds will grow within an investment environment that is free of UK tax on the investment income and capital gains, though the fund will not be able to reclaim the tax credit on UK dividends.

Contributions can also be free of inheritance tax if the £3,000 annual gift allowance is available or if payments can be considered to have been regular and made out of normal income, so that they do not reduce the donor's usual standard of living.

The main drawback is that the child will not actually be able to access these pension benefits until age 55. So it will not help with all those earlier needs such as university costs and house purchase. But in one respect this could be seen as a blessing in disguise, allowing sufficient time for the contributions invested to enjoy a significant level of appreciation.

Starting a pension plan can only be done by a parent or legal guardian and control of it then switches to the child at age 18. Once the pension has been opened, however, grandparents or others can make contributions each year up to the limit – currently £3,600 before tax relief.

While your post Christmas thank you letter may be a little cooler than usual, you may be able to console yourself by remembering that, to borrow a phrase, a pension is for life, not just for Christmas.