FINANCIAL FOCUS

KEEPING YOU UP TO DATE WITH DEVELOPMENTS IN FINANCIAL PLANNING

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Welcome to the summer edition.

Our last newsletter drew attention to the prospect of stock market volatility returning after a period of almost uninterrupted growth since March 2003.

My own belief is that the markets may well see some sort of correction in the coming months or year. Many markets are now trading at levels that look stretched measured against historical valuation tools. This is particularly so in some of the emerging markets, which have enjoyed strong growth over the last two or three years.

Experience tells me that trying to predict stock market weakness is impossible, but I believe investors should be conscious of where we are in the current cycle. Those with capital invested for the long term should not be concerned. However, if you have short-term requirements for money currently invested in the markets, particularly where you have enjoyed substantial profit, now may be the time to reappraise your strategy.

This newsletter contains comment on IHT planning and how to mitigate this tax. You can contact us to request a guide on all the rules or visit our web site and download our Guide to Estate Planning.

Please contact us if you require further information on any of the articles or would like to arrange a review.

More estates fall into the IHT net

First the good news: the tax nil rate band – the amount of your estate that is inheritance tax (IHT) free – is to rise to £350,000.

Now the bad news: this change will not happen until 6 April 2010. Meanwhile the nil rate band is £300,000 in this tax year, £312,000 in 2008/09 and £325,000 in 2009/10.

When Gordon Brown became Chancellor in May 1997, the nil rate band was £215,000 and the average house price was £58,196 (source: Nationwide Building Society). As of March 2007, average house prices have now risen by over 200% and the nil rate band has increased by 39.5%.

Fortunately all is not lost if you are concerned about inheritance tax on your estate (or your parents' estate). There is a range of tried and tested methods that can help you mitigate the impact of the tax.

The first and most basic is to make sure that your will is up to date. A properly drafted will could save your dependants up to £120,000.

After updating wills, you should try to take maximum advantage of the various IHT exemptions. For instance, regular gifts out of income are free of inheritance tax, provided these do not reduce your standard of living.

Inheritance tax planning should be integrated into your overall financial planning: there is no point in minimising inheritance tax if you suffer tax-efficient poverty as a consequence. For an initial discussion on your IHT plans, why not call us now?

The FSA does not typically regulate IHT planning.

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Weighing up your retirement options

When it comes to taking income from a pension plan at retirement, most people's default option is to buy an annuity. The main advantage of an annuity is that it will not run out until you die; the principal drawback is that annuities are not flexible, so you cannot vary the income from them year by year to meet your changing needs.

"...if you die before age 75, the value of your pension fund.... can normally pass to your chosen dependants as a lump sum, free of IHT."

Fortunately there is now a growing range of new alternatives when it comes to your retirement options.

Before age 75...

The main alternative to annuities before age 75 is pension fund withdrawal, which traditionally has involved drawing income from your pension fund investments. The maximum permitted income initially is about 120% of what an annuity could provide and the minimum is nil. This structure of income drawdown offers considerable flexibility and means that if you die before age 75, the value of your pension fund (less a flat 35% tax charge) can normally pass to your chosen dependants as a lump sum, free of inheritance tax (IHT).

However, the fact that your pension funds remain invested means that there are risks: if market conditions are poor, your income could fall and perhaps never recover. This has been the fate of some of the first investors to opt for income withdrawal when it became available in 1995. With hindsight, many of them would have been better off with the guaranteed income provided by an annuity.

The obvious solution would be to build some form of guarantee into the income withdrawal process. At the time of writing, three companies had developed drawdown plans that incorporate income guarantees. Two of these plans allow you to invest in a range of funds, without the risk of stock market fluctuations potentially forcing a reduction in your income. The third plan can give you a guaranteed income and a guaranteed lump sum after a fixed term of five or more years (but before age 75). That lump sum must be used to provide further retirement income.

From age 75...

Until last year, if you chose income drawdown you had to buy an annuity by the time you reached age 75. This changed from April 2006, with the introduction of alternatively secured pensions (ASPs). These allow a restricted form of income drawdown to continue after age 75 and the remaining fund can be passed on subject to IHT. In the March Budget, the Chancellor confirmed that such transfers would also be subject to income tax charges of up to 70%.

These tax charges make transferring the ASP fund very unattractive as a means of estate planning. However, ASP may still be preferable to an annuity in some circumstances, for example, if you need income flexibility, have a much younger spouse and/or wish to leave your pension fund to charity on death.

As with pension fund withdrawals, for ASPs your starting point is to take advice. If you want to build your pension into your estate planning after age 75, there are still opportunities to do so.

Where did the Budget leave you?

This year's Budget – Gordon Brown's finalé as Chancellor – was a shocker. It was not until the very end that the Chancellor produced a rabbit from the hat in the form of a surprise 2% cut in the basic rate of tax. However, the tax cut was not all it seemed.

HM Revenue & Customs issued 81 sets of Budget Notes after the Chancellor sat down, and it was in these that the detail of the Chancellor's proposals could be found. Predictably, much had been unmentioned in the Budget speech.

Income Tax and National Insurance Contributions

The headline-grabbing 2% cut in the basic rate of income tax to 20% will not take effect until next tax year – after 5 April 2008. What is more, the Chancellor announced two changes that will mean that some taxpayers will lose out:

- The 10% income tax band (covering the first £2,230 of your taxable income in 2007/08) will no longer reduce the tax burden on your earnings or pension income in 2008/09. The 10% rate will still cover savings income (eg deposit interest), but very few people will see any of their income taxed at 10% because savings income is only taxed after earnings and pensions.
- Some people will pay national insurance contributions on much more of their earnings. The increase will be introduced over the next two years. By 2009/10, you will be paying the full rate of NICs on roughly the first £43,000 of earnings compared to only £34,840 this year. The full rate of NICs is 11% or 9.4% for employees and 8% for the self-employed.

Small Companies and Corporation Tax

Small companies will now pay more tax on their profits. The corporation tax rate for companies with profits of up to £300,000 has been increased by 1% to 20% from April 2007. It will rise by a further 1% in 2008 and again in 2009, when it will be 22%.

If you have a small company, it is almost certainly still worth paying yourself in the form of dividends rather than salary, but the advantage is less than it was. The flip side of higher

corporation tax is that your company's pension contributions will now benefit from more tax relief.

Pension Term Assurance

Tax relief for new individual pension life cover policies has been withdrawn in another government pension U-turn. So if you have an existing personal pension term policy where the premiums qualify for full tax relief, you should think very carefully before cancelling it.

The removal of tax relief only applies to personally paid premiums on individual policies. Employers continue to receive tax relief on their premiums to provide group life cover for employees, so the value of this particular employee benefit has effectively been increased.

Individual Savings Accounts

You will be able to invest slightly more into your ISA each year. The Budget announced an increase, but only by £200, and then not until April 2008. Of the £7,200, up to £3,600 may be invested in a cash ISA. For the current 2007/08 tax year, the limits remain at £3,000 for a cash ISA or £7,000 for a stocks and shares ISA, while the overall annual ISA limit will stay at £7,000.

If there is a single lesson to be drawn from the Budget, it is that genuine tax cuts are not on the agenda. What the Chancellor has given with one hand, he has taken with the other. If you want to cut your tax bill, look to your own financial planning, not generosity from HM Treasury.

Remember that tax rules can and do change and you need to plan in the light of your own individual circumstances. The FSA does not regulate tax advice.

"What the Chancellor has given with one hand, he has taken with the other."

Planning against inflation

Since the turn of the century, average prices have risen by over a fifth and now they are rising much faster, according to official sources. When thinking about pension and investment income, the temptation is to ignore the way inflation eats into spending power. Protection against inflation is still essential.

Part of the problem is that some of us were lulled into a false sense of security when annual inflation dropped below 1% at the end of 2001. The talk then was of the potential problems of deflation, ie falling prices.

A little over five years later and the concerns are rather different. The March 2007 retail prices index (RPI) figure was 4.8%, its highest level for almost 16 years. Spiralling utility bills were a major culprit – the 'fuel and light' component of the RPI was up over 24% in the year to March 2007. Most economists agree with the Bank of England that inflation is likely to fall from current levels, if only because utility bills look likely to drop over the next twelve months.

You may have wondered why the government's figures for inflation seldom match your own experience with your household bills. In fact the government works out the impact of inflation by measuring the price movements of a wide range of goods and services.

If you live on your pension and investment income, the chances are that you spend a good deal more on Council Tax, heating and personal services – where the costs have shot up. But you probably spend little, if anything, on computers and iPods, where prices have generally dropped.

This has implications for your pension and investment planning.

Pensions

In an ideal world, all your pensions would be inflation proofed. However, buying inflation protection is costly. For example, it costs almost two-thirds more for a 60 year old man to buy £1,000 of pension annuity income that increases in line with inflation, than an annuity paying a fixed amount throughout his life. For a woman of the same age, the extra outlay is over 70%.

If your pension planning does not allow for inflation in retirement, you run the risk that your standard of living will gradually fall as the buying power of your income is chipped away by inflation. Even if prices rise at the rate of just 2.5% a year, you will lose over a fifth of your buying power every ten years.

Investments

You should build inflation into your investment planning in retirement. There are different ways of achieving this. If you rely on interest from deposit accounts, you can put aside some of the income as a reserve for the future, but in practice that can be hard with tax and fluctuating interest rates.

An alternative is to invest in assets that have provided some long term protection against inflation in the past – such as shares and property. We can design a portfolio that will produce an income that is aimed to last. But the value can go down as well as up and past performance may not be repeated in the future.

If you are concerned that the long term value of your income in retirement may not keep pace with rising prices, please contact us for a review.

Shoring up against market turbulence

Did you feel the earth move at the end of February?

On 27 February 2007, world stock markets experienced a serious tremble, with the US market falling 3.3%, its seventh largest ever one-day decline. All sorts of reasons were put forward, from the threat of capital gains tax on Chinese investors to an attempted suicide bomb in Afghanistan directed at the visiting US Vice President, Dick Cheney.

The turbulence was short-lived and six weeks later the brief flurry had been largely forgotten, with markets focused on a spate of takeovers, rumoured and actual. Where the market heads next is now the subject of some debate, given conflicting signs about the health of UK plc and the global economy.

One way to avoid falls in the stock market is to hold cash, which cannot lose value. But in such circumstances, holding cash has its own risks. While you would be immune to any stock market fall or inflation, you would also miss out on the benefit of any market rise.

If you want to keep your exposure to share-based investments, but limit your potential losses, there are now a variety of investments to meet your requirements. For example:

- You could have a fixed term investment plan that gives you capital protection with a return linked to stock market performance. Several investment providers have this type of contract. National Savings & Investments regularly offers just such a plan, but the deposit-based structure makes it tax-inefficient for most investors, compared to other products.
- You could invest in a fund with 'rolling protection'. This would mean that your capital is protected from loss beyond a specified level (usually between 0% and 5%) each quarter or each year. The higher the potential loss, the greater your exposure to the performance of the stock market.
- You could choose one of the range of funds designed to give a floor to the fund price of, typically, 80% of the highest-ever level. These types of fund offer a wider choice of underlying investment than the fixed term and rolling protection funds.

Past performance is not a guide to the future and investment values can go down as well as up, so you may not get back the full amount you have invested. Some of these investments involve penalties on early redemption.

Is your deposit account up to scratch?

Any advertisement for an investment fund normally carries the warning that its capital value and income can go down as well as up. There is no such warning for deposit accounts.

While capital values of deposits are fixed (ignoring the effects of inflation), income from most deposits is variable. The extent to which it varies can be very marked. For example, with base rates at 5.5%, a 0.25% interest rate cut would mean a reduction of £45.45 a year on a base rate-linked income that is currently £1,000 a year. Less than four years ago, base rates were at 3.5%, and if rates were to return to that level, your interest from a deposit account linked to base rates would fall by over a third.

What is more, banks and building societies have become masters at the art of tweaking rates, and sometimes do not give investors the full value of Bank of England base rate increases. One high profile bank has gone as far as to ignore several base rate increases completely. On the other hand, whenever base rates are cut, the reductions are often fully reflected in the interest rates offered to investors.

Deposit accounts certainly have their place, but they can have significant drawbacks for generating a dependable income.

If you want more certainty about the payments into your bank account, there are plenty of options available, although you should take their tax treatment and the possibility of capital erosion into account.

Guaranteed Income Bonds give you a fixed income for your chosen term and full capital return at maturity, although if you cash in the bond before maturity, you may receive less than your original investment. If you are a higher rate taxpayer, these bonds have two useful tax advantages:

- Your higher rate tax liability is 20% of the net income you receive, whereas for a deposit it is 20% of your gross income.
- The whole of your tax liability on the income will generally be deferred until maturity.

Fixed Interest Funds invest in fixed interest securities, such as government bonds (gilts) and corporate bonds. The income from these funds is not fixed, but varies according to the underlying investments. However, fund income is not linked to base rates and is normally more stable than deposits. If these funds are held in an Individual Savings Account (ISA) or a Personal Equity Plan (PEP), interest is paid tax free. Unlike deposit accounts, this is an investment where capital values can go down as well as up and past performance is not a guide to future performance.

Withdrawal Schemes are widely used to provide regular payments from a variety of investments such as funds or investment bonds. You choose how much you wish to withdraw and the payments are made regularly to your account. The payments are normally a mixture of income and capital, so if your rate of withdrawal is higher than the overall return on your investment, the value of your investment will be eroded.

Withdrawal schemes are particularly suited to investments where the bulk of the expected return is through capital growth. The value of these types of investment can fluctuate and you may not get back the full amount you invested.

Do your homework on school costs

Every parent wants the best for their children, not least when it comes to education. Many are now finding themselves faced with the dilemma of whether to move house or to pay for their children's schooling.

Private school fees have traditionally risen faster than most other prices as measured by the Retail Prices Index. In 2005/06 – the latest year for which figures are available – fees rose by 5.7% on average according to the Independent Schools Council (ISC). Even this high figure was the lowest increase recorded since 1999.

The relentless rise in school fees has not yet resulted in a shrinking number of privately educated pupils, currently around half a million. One reason why spiralling costs have not been a deterrent is the average class sizes in the private sector. According to the ISC, in 2006 the average pupil/teacher ratio was less than ten to one. In the state-maintained sector, the corresponding 2005 figure for English secondary schools was over 20 to one. Over 11% of state pupils were in class sizes greater than 30.

As an alternative to paying high school fees, many parents consider moving into the catchment area of a good state school. But this also has its price. According to some research undertaken last year, properties in the catchment area of a good state school can be worth up to £25,000 more than those on the wrong side of the dividing line. Research has also revealed that only 3% of pupils in the top state schools have free meal entitlements – a key measure of deprivation – against 17% nationally.

Your education choice could therefore be to pay up on school fees or pay extra on your mortgage to buy in the right catchment area. If moving looks the better option, be warned that you may not get the catchment area premium back when you sell and you may not even achieve your goal. New admission rules introduced for 2008 mean that some over-subscribed schools may resort to lotteries to allocate pupil places. Just such a system was announced in Brighton earlier this year, provoking howls of parental protest and garnering nationwide news coverage.

Whatever route you choose, as far as possible you should make sure that you stick to it. Once a child is settled in a school, it can be very disruptive for their education if they are moved elsewhere. Keeping your family protection cover up to date is one way to provide that all-important continuity. If the money is there – even if you are not – your child's education can continue uninterrupted.

Sending your child up the aisle

If you have an unmarried daughter, or even son, have you ever thought how much their wedding might cost you?

In 2005, the average wedding cost £19,500, according to 'You and Your Wedding' magazine. Add a couple of years' inflation since then and we are already talking about an average of over £20,000.

The good news – until you think about the effect of a few more years' inflation – is that the age of marriage is rising. National Statistics figures show that in England and Wales in 2005, the average age at which a woman first married was 29, four years later than in 1991.

While marriage rates have been falling for some years, hoping your children will stay single is not a particularly positive strategy. 2005 saw nearly 175,000 single women get married in England and Wales, which puts all the press coverage of marriage's demise into perspective. Over 65,000 divorced women remarried in the same year.

The cost of a wedding is not the only thing that children (daughters and sons) look to their parents for these days. 'The Bank of Mum and Dad' can also find itself the first port of call when it comes to financing a deposit on a first home, buying the first car (no longer a £100 banger) or bridging a shortfall in university costs.

Meeting some or all of these various outlays has become part of the cost of raising a family. Some of the timing is predictable – like the car and university costs – but some is not.

Nevertheless, the sensible thing to do is start planning for the costs as soon as is practical. This could mean:

- Setting up regular savings plans that are earmarked for specific events, such as a wedding. Discipline is needed here, as it is sometimes too easy to convert the wedding plan into the new car plan.
- Investing a capital lump sum for your children – perhaps using a trust. It may be possible to arrange the investment in such a way that any income tax eventually falls on your child once they have reached at least age 18. Before that age, tax liabilities will often fall back on you.
- Making maximum use of the top up facilities for Child Trust Funds, if your child was born after 31 August 2002. The maximum top up investment is £1,200 per year (based on the child's date of birth, not tax years). For a first child, this amount is more than covered by the combination of Child Benefit (£18.10 a week – £941 a year – in 2007/08) and Child Tax Credit (typically £545 a year at current rates after the first year).

The advance planning may not provide a complete solution, but it should make things more manageable. If there's still a shortfall, you could always try asking *your* parents!

"While marriage rates have been falling for some years, hoping your children will stay single is not a particularly positive strategy."

Covering recruitment

Alan Sugar may have no difficulties in finding potential recruits for his businesses, but outside the world of such television programmes as 'The Apprentice', life is rather different. You may have experienced this yourself, if you have tried to hire any senior staff recently.

Finding the right people is never easy, even at the best of times. Imagine how much more arduous it would be if the person you were trying to replace had given no warning of their departure, and could therefore not bring their successor up to speed during a probationary handover period.

This is what could happen if one of your key people were to suffer a serious illness – perhaps a sudden heart attack – or die. The probability of this happening to any single individual is small, but the more key people you employ, the greater the overall chance that such an unwelcome event could occur over the years.

Surprisingly, Alan Sugar provides a clue to one means of solving such a problem – money. If there is enough cash in the business, you can probably ride out the time it takes to recruit the right new employee and bring them up to full productivity. That may initially mean employing an 'interim executive' to cover the time lost to the search and selection process – along with a possible notice period for the chosen candidate.

The funds needed to finance the interim executive, the recruitment process for the new employee and the likely hit to profits could be significant. The simplest way to make sure that the funds are available when it matters is to set up appropriate life and critical illness insurance cover on your key employees. The cost may be surprisingly low, as the protection market remains fiercely competitive.

Are you contracted out?

If you use a personal pension to contract out of the state second pension (S2P), you should review your position. Contracting out may no longer be the right choice for you. The national insurance rebates paid to your plan have changed for 2007/08. Some rebate levels have risen, but others have fallen by nearly 30%.

ISA contributions

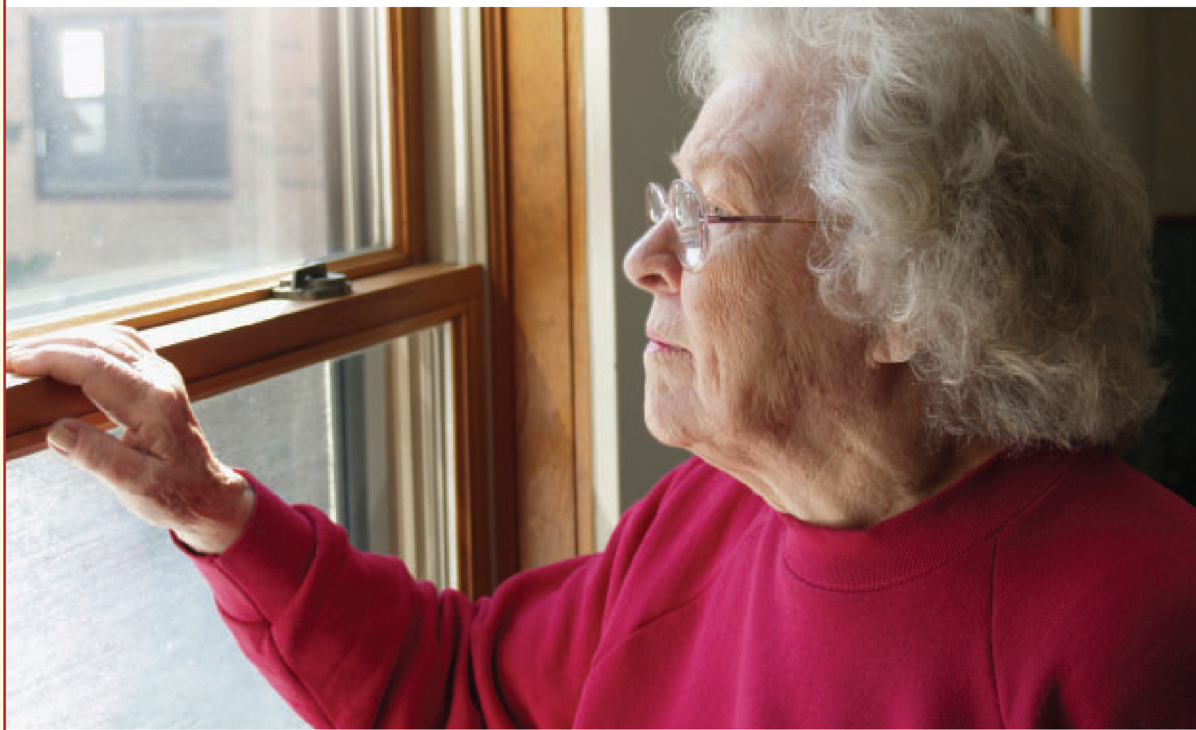
Don't wait until next March to invest in your ISA! To maximise the tax benefits, you may wish to consider investing for as long as possible, by contributing now, not in nine months' time. The current ISA rules will continue until at least April 2011, but tax rules generally change. Non-cash ISAs can fluctuate in value and you may not get back your original investment.

Taper Tops

6 April 2007 was a capital gains tax landmark. Any capital gains tax liability on ordinary investments you owned before 17 March 1998 is now subject to the maximum possible taper relief of 40% of the gain. So if you have a gain of £15,000 on an investment, the relief will bring the taxable gain down to £9,000 (£15,000 x [100% – 40%]). In most cases, that would be covered by this year's annual capital gains tax exemption of £9,200. Tax rules change and the FSA does not regulate tax advice.

The future of state pensions

If you want to know what pension the state will provide you with in the future, there are now some reasonable answers in the Pensions Bill 2006. Unfortunately, the Bill is light on some detail – such as start dates – but the broad outline is clear:



- Annual increases in the basic state pension will be greater. Currently £87.30 a week for a single person in 2007/08, it will rise in line with earnings rather than prices. The Bill does not say when this will happen, but previous consultation papers suggested that the improvement would begin between 2012 and 2015.
- The number of years you need to pay NICs to qualify for the full basic state pension will be reduced. If you reach state pension age (SPA) after 5 April 2010, then you will only need a record of 30 years' national insurance contributions (and/or credits) to qualify for a full pension. Currently the requirement is between 44 years (SPA 65) and 39 years (SPA 60).
- The age at which you can draw state pensions will rise. The SPA will increase to 66 between April 2024 and April 2026. Another year will be added in 2034/36 and again in 2044/46, by which time SPA will be 68. It has already been announced that women's SPA will gradually rise from 60 to 65 between 2010 and 2020.
- The state second pension (S2P) will slowly move from earnings-related to flat rate. However, the structure of national insurance contributions will not change. The transition should be completed by around 2030, according to Department for Work and Pensions estimates. S2P will by then be providing a flat rate pension of around £3,400 a year in 2007/08 terms.

The improvements are welcome, but gradual and will probably not make a great difference to your retirement income.

The major winners will be the low paid, who should gain more from the improvements to basic state pension than they lose from the move to a flat rate S2P. But higher earners are likely to be worse off, with lower S2P benefits more than cancelling the basic state pension changes.

State pension benefits have never been enough to provide a comfortable retirement, and in that respect nothing has changed. No wonder the government is working hard to encourage private provision alongside its other pension reforms.