EQUANIMITY
INDEPENDENT FINANCIAL ADVISERS

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# IHT demise exaggerated

**A couple of years ago, inheritance tax (IHT) grabbed the headlines, with one national newspaper running a high profile campaign for its abolition. But, once Alistair Darling had announced in the 2007 Pre-Budget Report that the nil-rate band (currently £325,000) would be transferable between married couples and civil partners, IHT began to fade from view.**

You might think that IHT is no longer an issue, except for multi-millionaires, but you would be wrong:

- If you are married or in a civil partnership and your total joint estate (including your home) is worth more than £650,000, then your beneficiaries could still see the Exchequer take a slice of their inheritance. For instance, on a joint estate of £1 million, the IHT bill is potentially £140,000.
- If you are unmarried, then IHT can be a more serious problem. On first death, spouses and civil partners can generally make gifts to each other free of IHT and transfer any unused nil-rate band to the survivor, but neither opportunity applies to unmarried couples. As a single person, IHT becomes relevant if your estate is worth more than £325,000.
- The complexities of IHT mean that you (or your executors) could face a tax bill because some aspect of your financial planning had been overtaken by legislative or other changes. One of the more obvious examples is an out-dated will – which might only be a few years old. (If you do not have a will, the rules of intestacy can easily create an unnecessary IHT liability, so it may be wise to draw up a will.)

Although IHT rules have been strengthened over the years, there is still a variety of schemes that may help limit the impact of the tax on your beneficiaries. A few of these arrangements have been in existence for many years and their effectiveness has been accepted by HM Revenue & Customs. However, IHT schemes can only go so far. If you are concerned about IHT, there is no real substitute for a thorough review of your financial planning with a close focus on its overall IHT effectiveness. Sometimes relatively minor changes can make a significant difference to the overall IHT liability.

Levels and bases of, and reliefs from, taxation are subject to change and their value depends on the individual circumstances of the investor. The Financial Services Authority does not regulate taxation advice, will writing and some forms of estate planning.

**Equanimity Independent Financial Advisers Limited**
98 White Lion Street
London N1 9PF
Tel: 020 7713 9356
Fax: 020 7837 7861
www.equanimity-ifa.co.uk
info@equanimity-ifa.co.uk

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# Building financial foundations

**There are now two really tax efficient ways to give grandchildren or other young relatives a valuable nest-egg for the future.**

First there is the child trust fund (CTF) from which every child born on or after 1 September 2002 benefits. The government contributes relatively small amounts to it, but the real advantage comes from the contributions that family and friends can make for a child.

The tax treatment of the CTF is very like an individual savings account. Any growth on the fund is tax free (apart from non-reclaimable tax credits on dividends) and there is no tax on any profit when the child becomes entitled to the fund at age 18.

The growth in the fund does not have to be reported to the tax authorities on a tax return, making the whole process very simple.

Grandparents (or anyone else) can also contribute to a CTF where the funds will benefit from these tax privileges. The maximum contributions are £1,200 to each CTF.

When the grandchild becomes 18 he or she may well be able to find a good use for the cash. For example, the CTF could be used to cover a substantial part of the costs of going on to higher education. Alternatively, the tax-free fund could be used to finance the deposit on a house, or even to help start a business.

But there is also a highly tax efficient way for grandparents or other family or friends to help build up funds for the long term. That is to invest in a personal pension arrangement for the child. The fact that the beneficiary will not be able to access the benefits until they reach the age of 55 might seem like a major drawback when compared with the CTF or other gift programmes. But it is because of the length of time that the funds are invested, combined with the tax privileges given to pensions, including 20% tax relief on the contributions, that the long-term benefits are likely to be so valuable.

Remember the old adage that the sooner you start contributing to your pension, the greater the benefits. The trouble is that most people simply cannot afford to make pension contributions in their 20s, so making contributions during their childhood and even into their teens provides a wonderful financial underpinning for the rest of their lives.

Levels and bases of, and reliefs from, taxation are subject to change. The value of investments and the income from them can go down as well as up and you may not get back the original amount invested.

**Did you know that if you do not file your tax return online, then normally you must file your paper tax return for 2008/09 by 31 October 2009?** Miss the Halloween date and you must file via the internet, which has a cut-off date of 31 January 2010. However, given the problems there have been in the past with last-minute filing, you would be well advised to make your online return as early as possible in the new year. Filing your return on paper does not alter the tax payment due dates, which remain 31 January and 31 July. The Financial Services Authority does not regulate taxation advice.

# The rising costs of education

**School fees increased by an average of 5.90% in 2009, according to the Independent Schools Council. Termly fees ranged from an average of £3,358 for day schools to £7,748 for boarding schools, although there was quite a range depending on the actual schools chosen.[1]**

If you can build up even a relatively modest education fund, you will find it can reduce the pain of the termly bill and tide over periods of financial hardship on redundancy or other difficulties. It is well worth parents saving, and grandparents or other relatives can be an invaluable help. Don't forget, leaving school will not be the end of education costs if the child goes on to higher education.

So, what types of investments could the parents and grandparents consider for funding the costs of education? The most important decision is the asset allocation. The shorter the period to paying the school fees or other costs, the less risk you can afford to take.

If you have at least eight years or even longer before you are likely to need to draw on the funds, you can probably afford to think about investing in more volatile investments and you should consider what proportion of your funds should be in equity-based investments. These can go down as well up and their past performance is not a reliable guide to their future returns.

Otherwise, you could stick to cash or possibly safe fixed interest bonds. However, if you are prepared to accept some risk to your capital, and to commit to tying up your cash on deposit (say, by investing for at least five years), the returns may be much better than if you want instant access to funds. But, of course, you run the risk of making lower returns, or even a loss.

Tax efficiency is also very important. There is now a wide choice of tax wrappers and the right one will depend on your individual circumstances. Past performance is not a guide to future performance. The value of investments and the income from them can go down as well as up and you may not get back the original amount invested.

[1] *Independent Schools Council (www.isc.co.uk/FactsFigures_SchoolFees.htm)*

# Higher rate pension relief hits trouble

**The government has reduced the tax relief on pension contributions for people with high incomes. This has implications for many people – not just the high earners directly affected.**

The restrictions will apply if your total income is £150,000 in the current year or was at this level in either of the two previous tax years. The new rules cover both individual and employer pension contributions into any registered pension scheme, ranging from personal pensions to final salary-related schemes. The higher rate tax relief is taken away through a special tax charge on you personally.

### Rules will be replaced

The rules were introduced in the Finance Act 2009 and will be replaced from 2011/12. For the tax years 2009/10 and 2010/11, people with incomes of at least £150,000 can still benefit from full tax relief on limited levels of contributions. The rules are complicated. Quarterly or more frequent contributions started before 22 April 2009 are basically not affected and there is an annual allowance of at least £20,000 of contributions, which can be higher in certain circumstances. Ask us for details if you think you might be affected now or in the future.

From 2011/12, the restrictions on tax relief are due to be generally tighter. For incomes of at least £180,000, the tax relief for all pension contributions will be at basic rate only. For incomes between £150,000 and £180,000, tax relief will be tapered down from the higher rate to the basic rate. Tax relief at your highest marginal rate will still be available for all pension contributions if your income is less than £150,000.

The restrictions raise the question of whether it makes sense to contribute to a pension if relief is limited to the basic rate. If you are a higher rate taxpayer in retirement, the rules mean you would have received contribution tax relief at a lower rate than you would be paying tax on your pension.

As is often the case with personal finances, matters are rather less straightforward. Ultimately, a decision about the relative benefits of 20% tax-relieved pension contributions will depend upon your personal circumstances and retirement planning objectives. If you are below the £150,000 threshold and qualify for higher rate tax relief, it is probably a good idea to take full advantage of the situation while it still lasts.

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**Did you know that from 6 April 2010 the minimum age at which you can start drawing pension benefits will rise from 50 to 55?** There are some transitional concessions, but they are strictly limited. If you were born between 6 April 1950 and 6 April 1955, the change potentially affects you. In practice, retiring before age 55 is a very costly exercise, but if you were thinking of doing so, your plans may need some revision. For example, you might need to arrange investments which can bridge the income gap until you can start to draw your pension.

# Planning for complicated lives

**The way we live is changing and for most people it is becoming more complicated. For example, 'boomerang kids' are much more common – those are adult children who leave home and then return, typically when times get tough. Nearly a third of men and a fifth of women aged 20 to 34 live with their parents, according to government figures.[1]**

Meanwhile, although the figures for divorce are at their lowest for over 20 years, that is mostly because far fewer of us are marrying in the first place. The number of marriages in the UK in 2007 (the most recent statistics) stood at 270,000 with figures for England and Wales the lowest recorded since 1895.[2] When we do marry, it is generally much later in life, in our 30s rather than our 20s and more of us are delaying parenthood.

These marked changes in the way many of us are now living have a major impact on personal financial planning, which needs to be flexible enough to take these new patterns for families into account.

Here are what we believe to be four key planning tips:

- Build up some short term savings or rainy day money for yourself. Don't depend on the availability of debt. You never know when you might need to draw on savings – separation, divorce, unemployment, short-time working, the non-appearance of an expected bonus.
- Make sure you have enough life assurance cover and that it is arranged so that the potential beneficiaries can be changed as circumstances alter over time. You will need both the cover and the trust wording to be flexible.
- Avoid expensive consumer debt and have some insurance that pays out if you fall seriously ill; the state does not provide generous sick benefits.
- Don't depend on your spouse or partner to do all the saving for retirement; it is a high risk strategy. You may not be together; they may not save enough for both of you and in any case it is generally much more tax-efficient for each partner to have their own source of retirement income.

Versatile and flexible arrangements, coupled with competent professional advice, should help you keep complex family finances running smoothly.

[1] *Source: www.statistics.gov.uk*
[2] *Source: www.statistics.gov.uk*

# Year-end planning decisions

**If your company's year end is 31 December, now is the time to start considering whether and how you should draw out your profits. In 2009, there is a new set of factors to consider alongside the normal issues:**

- The new rules on pension tax relief for higher earners (see 'Higher rate pension relief hits trouble') may limit the appeal of pension contributions.
- The smaller companies' corporation tax rate is due to rise to 22% from April 2010.
- From 2010/11, the top income tax rate will rise to 50% (42.5% for dividends) and personal allowances will be phased out if your income exceeds £100,000.
- The government has so far not taken any definitive action on family company dividends, although it continues to say the matter is under review.

The first two points tend to favour retaining profits within your company, while the other two argue for drawing profits out now. If you opt for drawing out profits, the mathematics of the bonus/salary/pension decision (assuming full contribution tax relief is available) for this year is shown below, based on a marginal £50,000 of profits.

If you are not affected by the new pension contribution tax relief rules, directing profits towards your pension could well be worth considering this year for two main reasons:

Your retirement fund may need rebuilding after the past two years' difficult investment market conditions.

There is a risk that restrictions on pensions tax relief will be tightened further by the next government, whatever its hue.

Levels and bases of, and reliefs from, taxation are subject to change.

**Bonus v Dividend v Pension**

| | Bonus £ | Dividend £ | Pension £ |
|---|---|---|---|
| Marginal gross profit | 50,000 | 50,000 | 50,000 |
| Pension contribution | | | 50,000 |
| Corporation tax | N/A | (10,500) | N/A |
| Dividend | N/A | 39,500 | N/A |
| Employer's national insurance contributions (NICs) £44,326 @ 12.8% | (5,674) | N/A | N/A |
| Gross bonus | 44,326 | N/A | N/A |
| Director's NICs £44,326 @ 1% | (443) | N/A | N/A |
| Income tax | (17,730) | (9,875) | N/A |
| **Benefit to director** | **26,153** | **29,625** | **50,000** |

*Assumptions:*
*Company's marginal corporation tax rate is 21% for calendar year 2009. Director's marginal income tax rate for 2009/10 is 40% (32.5% for dividends less 10% tax credit). Anti-forestalling measures do not apply to the director, limiting tax relief to 20%.*

# ISA top-up time

**In his April Budget, the Chancellor announced an increase in the contribution limits for individual savings accounts (ISAs). The lateness of the Budget and, probably, the tightness of government finances, meant that the increase was staggered:**

- From 2010/11 the maximum overall contribution will rise from £7,200 to £10,200 of which £5,100 (previously £3,600) may be invested in a cash ISA.
- If you were born before 6 April 1960, these higher limits will apply for 2009/10, but only for contributions made after 5 October 2009.

If you are 'mature' enough to benefit from October, then do ask for our advice before investing. For example, if you have already contributed to an ISA in this tax year, your options may be constrained by rules which say you can only contribute to one cash ISA and one stocks and shares ISA during the tax year.

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