money wise

Autumn 2009

In this issue: Building financial foundations • Higher rate pension relief in trouble • The rising costs of education • Planning for complicated lives • Escape your bonds? • IHT demise exaggerated

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Building financial foundations

There are now two really tax efficient ways to give grandchildren, or even unrelated individuals, a valuable nest-egg for the future.

The child trust fund (CTF) was introduced with effect from 6 April 2005 and every child born on or after 1 September 2002 benefits. The government pays £250, once at birth in the form of a special voucher for each child, and then again when the child reaches the age of seven. If the voucher is not invested within a year, HM Revenue & Customs will open a stakeholder account on the child's behalf.

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 a year 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.

Personal pension arrangements

But there is also a highly tax efficient way for grandparents, or other family or friends, to help build up finds 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 – for example, 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, that the long-term benefits are likely to be so valuable.

Uplift and growth

The great advantage of making a pension contribution is the tax position. There is tax relief on the input so that the grandparents can pay up to £2,880 into the plan, but the government then tops it up to £3,600 with £720 of tax relief. That is an immediate uplift of a quarter of the net contribution. The funds then grow in a fund that is largely tax free – apart from the non-reclaimable tax credits on dividends. When the beneficiary wants to draw on the funds – after they reach the age of 55 years – up to a quarter of the fund will be free of personal tax and the rest must be used to provide a taxable lifetime income, which is generally paid as an annuity.

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

A grandparent could spread any amounts they were prepared to invest between the CTF and a personal pension arrangement to achieve the nest-egg they would like for their grandchild or grandchildren.

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.

Higher rate pension relief in 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 schemes 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. 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 basic rate relief. 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.

Levels and bases of, and reliefs from, taxation are subject to change and their value depends on the individual circumstances of the investor.

The rising costs of education

School fees increased by an average of 5.90% in 2009, according to the Independent Schools Council.[1] 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.

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 family members 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 investing for at least, say, 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.

The FSA does not regulate tax advice or school fees planning. 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. Source: www.isc.co.uk/FactsFigures_SchoolFees.htm

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 things to consider:

- Build up some short-term savings for yourself. Don't depend on the availability of debt. You never know when you might need to draw on savings: separation, divorce, unemployment, illness or 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 sickness benefits.
- Don't depend on your spouse or partner to do all the saving for retirement; it is a high-risk strategy. By retirement 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

Escape your bonds?

If you have a one-year bank or building society bond about to mature, you may find that your money is going to be automatically transferred to an account paying minimal interest. For example, Northern Rock pays just 0.25% on its matured bonds at the time of writing.[1] Some deposit takers will roll over your investment into a new bond for the same term, but give you the option of withdrawing penalty-free within a month.

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Twelve months ago, when bank base rates were 5%, you could find one-year fixed rate deposits paying 7% gross interest. It was a tempting offer, particularly given the turbulence in the stock market at the time.

Now those bonds are maturing and the interest rate picture is very different. Base rates have fallen to 0.5% and the best one-year fixed rate bond is offering below 4%. There are slightly higher rates for longer term deposits, but nothing approaching 7%.

If your main goal is income, in the current environment there is no avoiding a substantial fall if you stick to fixed term deposits. However, if you are prepared to accept the risk of losing some or all of your capital, there is a wide range of investment funds which currently offer higher levels of income than one-year deposits. For example:

- Corporate bond funds, which invest in fixed interest securities issued by companies.
- UK equity income funds, which generally invest in shares with a higher than average dividend yield.
- International equity income funds, which focus on higher yielding shares outside the UK.

All three fund types can be held within an individual savings account (ISA), but do not afford the same capital security as a deposit account. ISAs are particularly suited to corporate bond funds, because the interest from these funds flows through to investors free of UK tax. The investment limit is double the cash ISA ceiling.

Levels and bases of, and reliefs from, taxation are subject to change and their value depends on the individual circumstances of the investor. The FSA does not regulate tax advice or deposit accounts.

1. Source: www.northernrock.co.uk/savings/saving-rates/fixed rate

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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.
- 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.

Although IHT rules have been strengthened over the years, there are 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 HMRC. 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.

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