EQUANIMITY
INDEPENDENT FINANCIAL ADVISERS

FINANCIAL REVIEW
Spring 2006

Tax planning time

Now that the Christmas and New Year celebrations are behind us, the time has arrived for a review of your tax planning. This year it is particularly important to make sure everything is in place before the Budget, which generally takes place in March.

Chancellors from both parties have tended to make the first Budget of the parliamentary term their harshest. The logic is that the Budget nearest the last election is the one furthest away from the next election. In Gordon Brown's case, a £10bn 'black hole' in public finances may encourage him to push through further tax rises in addition to the increased tax on oil companies announced in December. Before the Budget (date as yet unannounced), the areas you should review include:

ISAs

Individual Savings Accounts continue to offer important tax benefits:

- Interest income from bond funds is free of all UK income tax.
- There is no additional tax charge on dividend income if you are a higher rate taxpayer.
- Any gains you make are free of capital gains tax.
- You have nothing to put on your tax return.

The value of ISAs invested in share or bond funds can fluctuate and you might not get back a significant proportion of your investment. Past performance is not a guide to future performance and may not be repeated.

Personal Pension Contributions

If you want to cut your tax bill in 2005/06, one simple solution is to make a contribution to a personal pension. If you are a higher rate taxpayer, a personal pension contribution could also reduce your income tax payments on account for the coming tax year.

If you are self-employed or you are an employee, but not a member of an occupational pension scheme, you can

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The Value of Dividends

Investors often forget the importance of dividends when looking at investment return. The explanation could be that the FTSE 100, as well as virtually all the other main stock market indices in the UK or overseas, are just based on share prices and ignore dividends.

Ignoring the impact of dividends is a particularly bad idea if you invest in UK shares, because they have a relatively high dividend yield – especially when compared to most overseas shares. For example, according to Barclays Capital, £100 invested in UK shares at the start of the 20th century would have grown to £13,396 by the end of 1999 assuming no dividends had been reinvested; but the value of the £100 would have grown to a staggering £1,285,872 (ignoring tax) including the value of the reinvested dividends.

Of course, unlike cash in deposit accounts, the value of shares (as well as the dividends from them) can fluctuate and it is possible you might not get back a significant proportion of your investment. Past performance is not a guide to future performance and may not be repeated.

In today's low inflation, low return environment, the current 3% yield on UK shares is a good starting point for overall investment returns. Even if you are looking solely for capital growth, it can make sense to choose an investment fund with a good level of dividend. Most investment groups allow dividends to be reinvested automatically or accumulated within the fund.

Equanimity Independent Financial Advisers Limited
15 Canonbury Park North
London N1 2JZ
Tel: 020 7710 5445
Fax: 020 7796 3483
www.equanimity-ifa.co.uk
helen@equanimity-ifa.co.uk

THE FUTURE OF YOUR PENSION

A key report

The Turner Report on pensions suddenly prompted politicians, journalists and experts to start a major debate about retirement issues, when the report was finally published in November last year. Named after the commission's chairman Adair Turner, the report was the product of three years' work, and contains a range of ideas that could radically change both state and private pensions, including:

- There should be a National Pensions Savings Scheme. All employees who earn over £4,895 a year (in 2005 terms) would be automatically enrolled, unless they already had good enough pension arrangements or they chose to opt out within the first month of membership. Contributions would be set at 3% for the employer and 5% for the employee (including about 1% tax relief), based on earnings between £4,895 and £32,760 a year in current terms.
- The state second pension (S2P) should lose its link to earnings and be gradually moved onto a flat rate basis, as originally intended.
- Contracting out of S2P should be scrapped for personal pensions and money purchase occupational schemes. For final salary pension schemes, contracting out should be phased out over about 20 years.
- The right to receive the basic state pension should ultimately become based on each individual's period of residence in the UK, rather than their national insurance contributions record. In the short term, everyone over age 75 should become entitled to a full basic state pension.
- Increases to the basic state pension should be in line with rises in earnings rather than prices.
- A form of the currently very complicated pension credit system should remain, but it should be changed so that many fewer people would receive it.
- Very controversially, state pension age should increase in line with life expectancy to 66 by 2030, 67 by 2040 and 68 by 2050.

The government has promised to respond by the spring, but even before the report was published, the Chancellor made it clear he was worried about the potential costs of changing the current system. In any case the politics look difficult: voters will like the idea of higher pensions, but not the extra taxes to pay for them nor the higher pension age.

If the reforms – or some of them – happen, the start date is highly unlikely to be before 2010. The report is most definitely not a reason to put retirement planning in abeyance for the next four years. In fact the report provides one good reason for making pension contributions now. The commission was very critical about the fact that 'a large proportion of all tax relief (over 50%) is received by the 12% of employees who pay higher rate tax'. Mr Brown may not have liked many other aspects of the report, but he might feel inspired to take action on pension tax relief.

A-Day arrives

The pensions world will undergo a radical change on 6 April or A-Day. Pension tax simplification will take effect after several years of deliberation. As a quick reminder, the main reforms will be:

- Today's eight different sets of rules for different types of pension arrangement will be replaced by one new set of rules that will apply to all pension schemes.
- Your pension benefits will be subject to a lifetime allowance, initially £1.5m. This will effectively set an upper limit on the value of tax-efficient pension benefits that you can have.
- The current limits on the amounts you can contribute to your pensions will disappear and instead you will have an annual allowance, initially of £215,000. Your maximum effective personal contribution to pension arrangements will normally be 100% of earnings.
- As a general rule, you may be able to draw a quarter of the value of all your pension arrangements as a tax-free lump sum.
- You will not have to buy an annuity by age 75, but you must draw any tax-free lump sum before then.
- There will be new rules restricting borrowing by pension schemes. However, following the Chancellor's unexpected change of mind announced in the Pre-Budget Report, investment in residential property and assets such as fine wine and antiques will be subject to severe tax penalties.
- The minimum age at which you can normally draw your retirement benefits will rise from 50 to 55 on 6 April 2010.

The new rules are accompanied by a raft of transitional reliefs, which will generally protect you from any tax penalty on actions taken or funds built up before A-Day. Some of these reliefs are given automatically, while others must be claimed.

Whatever pension arrangements you have – or even if you have none – simplification means that you should arrange for a review of your retirement planning. The new rules open up many new opportunities, but also call into question some traditional ideas. For example, if you are a private company shareholder/director, from April you might find it makes more sense to contribute to a self-invested personal pension (SIPP) rather than a small self-administered scheme (SSAS). At present the SSAS is more attractive because the contribution limit is normally higher, but from A-Day this difference disappears.

Not everyone will be better off under simplification. You might find that from A-Day it will not make financial sense to contribute to a pension plan. For that reason, if no other, you should talk to us before making any pension contributions after A-Day. Ideally, talk to us now: there may still be some pre A-Day opportunities worth examining.

90 YEARS YOUNG

How many years of retirement would you expect a man aged 65 today to enjoy?

The answer is 21 years and seven months, according to research published by the UK Actuarial Profession in September 2005 on pensioner mortality. If you guessed a lower number, then you are in good company. Medical advances and healthier lifestyles mean life expectancy has increased much faster than many people – including the actuaries – anticipated.

In 1994, a 65 year old man would have looked forward to three and a half years less retirement. Go forward ten years to 2015 and you will see that the actuaries' central estimate is that a 65 year old man will die just two months before his 90th birthday. And of course, women are expected to live even longer.

While we all welcome longer life expectancy, there are important consequences, both at a personal and a national level. For example:

- Living longer means that pensions will cost more – hence the proposal in the Turner Report for raising pension age (see 'The future of your pension').
- Annuity rates will potentially only get worse (unless long term interest rates rise) because insurers will be paying out to pensioners for longer.
- If you do not build inflation protection into your pension, then your standard of living could fall a long way in the many years of retirement. For instance, over 20 years, 2.5% inflation will wipe nearly 40% off the buying power of a flat rate pension.
- Children waiting for an inheritance from their parents may find that by the time it eventually arrives, most of it has been spent, possibly on long term care. Worse still, for what funds are left, it might make more sense to skip a generation and pass them to the grandchildren. After all, by then the grandchildren may be in their early 40s and starting to worry about their retirement planning!

Inheritance tax net spreads

Inheritance tax (IHT) is turning into a significant money earner, according to two studies published in November 2005 by Halifax Bank and Grant Thornton, the accountants. Their findings were largely based on data from Her Majesty's Revenue & Customs (HMRC). Here are some examples of what they discovered:

- The total amount of IHT and the number of estates affected in this tax year have more than doubled since 1996/97, according to their projections.
- If the government scrapped IHT, they would need to increase basic rate income tax, NICs or VAT by 1% just to replace the lost government revenue.
- In one out of ten local authority areas, the average house price now exceeds the £275,000 starting threshold (nil rate band) for IHT for 2005/06. Five years ago, the average price of a property exceeded the nil rate band (then £234,000) in only one out of 50 local authority areas.
- If the nil rate band had been indexed in line with property values over the last ten years, it would now be some £406,000 – nearly 50% higher than its actual value.

IHT is a tax that the Chancellor has been happy to leave largely unchanged since he first came into office. If people's personal wealth rises faster than retail prices, which is what generally happens over the years, IHT will produce more revenue each year, even when the nil rate band is inflation-linked. As a tax IHT has several advantages for the Treasury: it is relatively easy to collect; it is usually only paid at death; the average tax payment is substantial; and HMRC have the whip hand because until they have granted probate, an estate cannot be distributed to the beneficiaries.

Both Grant Thornton and the Halifax called for a review of IHT, but it seems unlikely that Mr Brown will take much notice. In the 2005 Budget he set the nil rate band for three years (it will be £300,000 by 2007/08), which suggests he has no plans for reform in the short term. In fact IHT is one of the few taxes that has not been subject to tinkering by the Chancellor over the last nine years.

If your total wealth is above the nil rate band of £275,000 – or is likely to be so in the future – the clear message is not to look to parliament for any help. The way to deal with IHT is through careful planning, maximising the use of the available exemptions and reliefs. There remain a number of specialist arrangements which reduce the impact of the tax, and to date HMRC have accepted them as being within the terms of the IHT legislation. Some of these allow you to make a capital gift, but still retain the right to regular payments throughout your lifetime. Don't forget that taxation rules and levels may change.

Let us know if you would like further information on how to pass more of your money to your family and less to the Exchequer.

Incapacity and your income

Would £76.45 a week be enough to turn you into a long term malingerer?

Less than £80 a week may not sound much, but that is the current level of long term Incapacity Benefit (IB) and it is causing the government some concern. One reason is that IB has seemingly turned into a form of state early retirement benefit. Between 1979 and 2004, the number of people aged over 50 claiming IB increased to 1.3m[1] – nearly a fourfold increase.

A Welfare Reform Green Paper was published by the government in January 2006 proposing changes to IB in an effort to limit expenditure. These include a reformed IB regime that will see payments cut for claimants who do not try to prepare for, or find, employment. The changes would follow on from an earlier reform to IB in 2000, which placed the focus purely on objective medical criteria and removed issues of age and skills from the assessment.

Unless you have some income protection in place, you could be forced to rely on Incapacity Benefit if an illness or accident were to keep you from work for a prolonged period. Even if your employer provides you with cover, you should check whether your payments would only last for a limited period.

You may be tempted to think 'it won't happen to me', but the number of people claiming IB underlines just how wrong you would be. You could even find that while you are unable to continue in your own job, the strict medical test rules mean that you cannot claim IB because you could carry out some other type of work. In contrast, claims under income protection are normally based on your inability to follow your *own* occupation.

If you do not have any income protection, or you have not reviewed your cover for some years, ask us now about setting the right level of protection for you. The alternative could be trying to live on under £80 a week – if you are eligible.

1. *Source: www.ft.com, 19 November 2005*

TUITION FEES INCREASE

This year marks the start of a new set of rules for student finance in England, which will affect your child – or grandchild – if they start a new course from this autumn onwards.

The only major exception will be for those who took a gap year in 2005/06 and by 1 August 2005 had a confirmed place for the 2006/07 academic year. Scotland, Wales and Northern Ireland each have different rules. The most controversial feature of the new English regime is that higher education establishments will be able to charge tuition fees of up to £3,000 a year – compared with the 2005/06 flat rate of £1,175. It already looks certain that the £3,000 maximum will be the norm, partly because of the parlous state of most universities' finances.

Students will not be required to pay the higher tuition fees up front, which for most students will be a welcome change from the existing system. Instead, the fees will effectively be covered by a government loan, which students will have to repay through a new Graduate Contribution Scheme once they have finished their courses. They must repay this fee loan and also pay off their maintenance loan before becoming debt free. Both types of loans will be interest-free but inflation-linked.

Students will have to repay their loans at the rate of 9% of their gross earnings over £15,000 a year. For example, a graduate earning £22,000 would have to repay around £630 a year. In practice, this level of repayment might pay off little or nothing of a student's total outstanding debt – which for someone graduating in summer 2009 could easily be £20,000. In such a case, the first £500 of repayment would merely cover the inflationary increase in the debt, assuming that inflation is 2.5% a year. Any graduate who becomes a higher rate taxpayer will suffer a marginal 'tax' rate consisting of 40% income tax, plus 1% national insurance, plus 9% loan repayment – equating to 50% of their salary.

If you want to ease the financial burden for a future student, there are several tax-efficient options available. The sooner you start, the better.

TESSA anniversary

1 January 2006 was the fifteenth anniversary of the introduction of TESSAs (Tax Exempt Special Savings Accounts). TESSAs were replaced by ISAs in 1999, but you may well have reinvested your matured TESSA in what was once called a TOISA (TESSA-only ISA). With low interest rates, returns on these can be disappointing. Now is a good time to review your options.

MANAGER CHANGES

The investment management industry seems to be going through a turbulent time in terms of personnel changes. Some leading individuals are switching between fund groups, and one of the UK's most respected fund managers, Anthony Bolton of Fidelity, is heading for retirement next year. If your funds are on the losing end, this could be a good time to review your investments.

Please remember…

DIESEL DEMISE?

If you are about to choose a new company car, do not forget that the rules for diesels will change from 6 April 2006. At present, a diesel car meeting Euro IV standards (as all new diesels do) is taxed in the same way as a petrol car with the same CO_2 emissions level. For 2006/07 onwards any diesel registered since 1 January 2006 will suffer an extra 3% loading (subject to a maximum benefit value of 35% of list price).

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normally make personal pension contributions. Even if you are a member of your employer's occupational scheme, you may still be able to pay something towards your pension in this tax year – ask us for details.

You can even make personal pension contributions of up to £2,808 (net) in 2005/06, without the need to have any earnings. You could also make the contributions of up to £2,808 (net) on behalf of your minor children, grandchildren or non-working partner. All contributions are made net of basic rate tax, so the actual amount invested in the pension plan would be £3,600 for a net contribution of £2,808.

Additional Voluntary Contributions

If you are a member of your employer's occupational pension scheme, you have two potential options:

- You can make additional voluntary contributions (AVCs) to top up your pension fund or, in some cases, you may be able to buy added years. Normally you can contribute up to 15% of your earnings (including the taxable value of fringe benefits such as the company car), less any pension contributions you have paid to the scheme over the year.

  From 6 April 2006, the new tax rules (see 'A-Day arrives') will mean that at retirement you can draw up to one quarter of your AVC fund as a tax-free lump sum. However, the rules of your AVC scheme will need to be changed to allow such a payment.

- You may be eligible to make a contribution of up to £2,808 (net) to a personal pension, as explained above.

- Remember, from 6 April the scope to make additional contributions will increase for almost everyone.

Contracting Out

If you use a personal pension to contract out of the state second pension (S2P), you should review whether to join the state scheme before the end of the tax year. The payments made by the government for contracting out are generally considered to be too low, but that does not automatically mean you should be a member of S2P. You should seek independent financial advice before making any decision.

Capital Gains Tax

The amount of capital gains you can make without paying tax in 2005/06 is £8,500. Investment market conditions were generally good in 2005, so you could use this annual exemption to bank some tax-free profits. If you do not use your exemption, it cannot be carried forward.

Remember, tax rules are subject to change.