EQUANIMITY
INDEPENDENT FINANCIAL ADVISERS

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HOW TAX-EFFICIENT ARE YOUR INVESTMENTS?

You can boost your net investment returns by making sure that you hold your funds in the most tax-efficient way – and the recent capital gains tax (CGT) changes have had an impact on this aspect of planning.

The most important determinant of investment performance is almost always the mix of asset classes, such as property, shares, fixed interest and cash, but the tax treatment of income and gains may make a big difference to the amount you actually receive.

For example, in some circumstances it is very worthwhile to hold certain sorts of investments through the medium of a UK or offshore life assurance investment bond. But in many cases, it is more tax-efficient to invest direct or through a collective investment such as a mutual fund or unit trust.

The decision depends on various factors. Investments that generate a high income may well be more tax-efficient in a bond; high growth oriented investments may often be better sitting in a collective or a portfolio of directly held investments.

The tax position of the investor is also crucial: trustees may well find bonds are more attractive than collectives or direct holdings in some circumstances. But each situation needs looking at individually.

Bonds and mutual funds are often referred to as tax wrappers, because they are wrapped round the basic investment in cash, shares or other securities. Choosing the right wrapper is important and the recent changes to CGT have altered the relative attractions of different wrappers to some extent. The new 18% flat rate of CGT means that many investors will now pay less CGT than before – but some will incur more tax than under the old rules because of the loss of indexation relief and taper relief.

Choosing the right wrapper is just one aspect of tax planning with investments. There is also the issue of who should hold them. If you are married – or in a registered civil partnership – you should also consider sharing assets with your spouse or partner to make the most of your tax allowances and reliefs. And if one of you is a higher rate taxpayer and the other pays tax at the basic rate or less, it could make sense to transfer some income-producing assets so that the income is taxed at the lower rate.

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Retirement choices

Are you planning to convert your pension fund into a retirement income soon?

If so, then the options open to you are greater than they have ever been. For instance, in the last few years:

- There has been a radical change to pension tax rules that has allowed companies to develop new, more flexible, retirement income products.
- Several insurance companies have launched innovative plans that can offer you a combination of guarantees and potential income growth. You should remember that investment values can fall as well as rise.
- Competition has increased in most retirement income sectors. The annuity rate you are quoted could now depend upon whether you are a smoker, your hometown postcode or your previous employment, among other factors.

The range of opportunities is extensive, but it often seems to be ignored. Before accepting what your pension plan provider offers, it is vital that you take advice. There are many factors that you should consider beyond the immediate amount of income available. For example:

- What provision do you wish to make for your partner and any other dependants?
- How important are guarantees to you?
- Will you want to vary your income in the future?
- Do you want to use your pension as part of your inheritance tax planning?

We can help you answer these questions. If you ignore them now, you could spend many years in retirement regretting it.

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Is your mortgage fully covered?

Mortgages have been making the headlines of late, and it has generally not been good news. Lenders have been pulling out of the market, demanding higher deposits and, at times, seemingly competing *not* to sell any mortgages. By June 2008, new mortgage lending had fallen by about a third, year on year, according to the Council of Mortgage Lenders. If you have an existing mortgage, you might be tempted to think 'so what?' Such a response could be foolhardy. For example, if you or your partner became ill and were unable to keep up your mortgage payments, what would happen?

In the current environment, your lender could be less keen than it once was to let you roll up interest payments until your health improves. Right now, that option might represent the lender's worst nightmare: a combination of rising debt alongside falling house prices. If your lender took the commercial decision to call in the loan, you might have no alternative but to sell the family home. 'No questions asked' instant remortgages may have been around in 2007, but since then they have gone the way of 100% loans and appear to have virtually disappeared. Wary lenders now want to see firm evidence of income and, preferably, at least 10% equity in the property (based on its *current* value).

In theory, some help is available from the state, but in practice it is often of limited use.

The current rules, which are due to change from April 2009, are that generally:

- If your mortgage started after 1 October 1995, you will have to wait nine months after making a claim before receiving any Income Support for Mortgage Interest (ISMI) payments.
- Interest at a standard rate (currently 6.58%) is paid only for the first £100,000 of your mortgage.
- If you have capital of more than £16,000, you will not be eligible for any support.

The potential problem is even worse if you or your partner were to die. Unless the survivor can maintain mortgage payments (and meet any additional costs, such as childcare), then the home will probably have to be sold.

The simple way to avoid these problems is to make sure that you and your partner have adequate health and life assurance covering your mortgage. The premiums are a small price to pay for peace of mind.

PS Do not forget that cover is also important for other loans, especially if they are secured on your home.

More CGT Payers This Year

While the rate of capital gains tax (CGT) has fallen, the latest statistics from HMRC show that the number of CGT payers is expected to rise by over a third this tax year. One likely reason is the loss of taper relief, which will mean larger taxable gains. The Financial Services Authority does not regulate tax advice.

University Fees Rise

The new academic year will be marked by a further increase in maximum student tuition fees to £3,145 in England and Wales. Although the student is automatically lent the money, usually it still has to be repaid with inflation-linked interest. Planning to meet education costs now needs to include funding for university unless you want your child to graduate into debt.

The right way to employ a spouse

If you are self-employed, or a shareholder director of a private limited trading company, you could be in a good position to save tax by employing your spouse or civil partner. This is particularly relevant if they have no other income and so have a personal allowance to set against any new income received from this 'employment'.

The tax situation might be even further improved if your business, or your partner, intends to make pension contributions.

HM Revenue & Customs (HMRC) insists that the spouse's or civil partner's income must be justified by the work he or she does in the business on real commercial terms. For the company contribution to a pension arrangement for your spouse or civil partner to be deductible from company profits before corporation tax is assessed, it must be made wholly and exclusively for the benefit of the trade.

Once this has been established, your spouse or civil partner could also make a pension contribution up to the level of those earnings or £3,600 gross, whichever is the greater, and automatically obtain basic rate tax relief on the contribution. The contribution would be paid net of this 20% income tax relief. So a payment of, say, £4,828 would mean the pension fund would ultimately benefit from £6,035 (the personal allowance for the tax year 2008/09). The balance of £1,207 would be made up by a payment of the 20% tax relief from HMRC. The pension contribution benefits from this relief, even though the spouse or civil partner may not have paid tax on his/her earnings of £6,035.

There is a sting in the tail. Your spouse or civil partner will have to pay a small amount of employee's national insurance contribution (NIC) if he/she will have earnings over the threshold – the amount will be about £64, reducing the amount available to £1,143. There may also be an employer's NIC of about £74.

These figures are extremely attractive compared to the net amount you would otherwise receive by paying tax and NICs yourself on money earned by the business or, if the business is a company, by retaining the cash in the company after corporation tax.

Of course, the drawback to investing in a pension is that you cannot normally have access to the funds until age 55 (50 before 6 April 2010) and they are then subject to HMRC restrictions on how you can take the benefits.

The value of tax reliefs depends upon your individual circumstances. Tax laws may change.The Financial Services Authority does not regulate tax advice.

PLAN AHEAD FOR PERSONAL ACCOUNTS

One of the biggest changes to pensions will be introduced later this year when the Pensions Bill 2007 becomes law. The new Act will create the legislative framework for 'personal accounts', and will create new responsibilities for all employers.

Starting from 2012, employees will be automatically enrolled into a personal accounts scheme if their employer does not already offer most employees access to a pension scheme with certain minimum standards. For example, an existing money purchase pension scheme must have an annual employer contribution of 3% and an overall minimum contribution of 8%.

The main features of personal accounts are as follows:

- The new rules will apply to *all* employers, unlike the current stakeholder pension employer access rules, which have an exemption for employers with fewer than five employees.
- Employees without adequate pensions who are aged between 22 and state pension age will automatically become members unless they choose to opt out. But their employers must re-enrol them at prescribed intervals which must be at least every three years.
- Employers will have to contribute to their employees' personal accounts. This will be phased in over three years. At present, there is no compulsion to contribute to stakeholder pensions. Broadly speaking, the employer contribution will be 3% of qualifying earnings – basically earnings on which employees pay the full rate of class 1 national insurance contributions (currently between £5,460 and £40,040). Employees will have to pay 4% of qualifying earnings and the government will add a further 1% in tax relief.

Checklist

2012 may seem a long way away, but these reforms will need considerable planning. If you are an employer, here is a personal account checklist:

- Will your existing pension provision satisfy the minimum standards?
- Should you set up provision before the government scheme is imposed on you and your employees?
- What impact will mandatory contributions have on your business?
- How proactive will you need to be in communicating the impending changes to your employees?

To start the ball rolling, why not arrange an employee pension review meeting with us?

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A GOOD TIME TO REVIEW YOUR PORTFOLIO

Global stock markets have had a difficult 12 months. A year of credit crunch, rising oil prices and increased inflation have all taken their toll. By the end of the second week in July, both the UK and US markets were in the territory that is often defined as a 'bear market' – a 20% fall in share prices from their peak.

This may not seem like a time when you would want to look at your investment portfolio, but a good case may be made for doing so while markets are depressed:

- You should always review your investment portfolio regularly anyway. Just because markets are down does not mean you should forget about the process.
- What has happened to the leading indices may not reflect the outcome for your own investment portfolio. For example, in the UK, bank and other financial shares have generally been hit much harder than mining and oil shares. Similarly, holdings in fixed interest funds have generally outperformed share-based funds over the last year.
- The relative movements in different investment sectors could mean that your investment holdings need rebalancing. When shares are falling faster than bonds, the balance in a portfolio may move towards greater bond holdings.
- Market downturns may throw up unexpected investment opportunities. When gloom pervades, prices are frequently pulled down across the board, seemingly regardless of the relative worth of the companies.

On this occasion, there is an added reason for taking a careful look at your investments: capital gains tax (CGT). In spite of all the doom-laden press coverage, the downturn may not have wiped out all profits. Many investments held for more than a few years may still be in the black, although not as much as they were 12 months ago.

If these investments now need to be sold as part of your portfolio review, then the smaller gains mean less chance that you will have to pay any CGT. Even if you do – which would mean realising gains in this tax year of over £9,600 – the maximum tax rate is now only 18%.

Past performance is not a reliable indicator of future performance. The value of investments and the income from them can go down as well as up and you may get back less than you invested. The Financial Services Authority does not regulate tax advice.

Trustee note: If you are a trustee, a review now may be even more important, because trusts normally have a smaller capital gains tax annual exemption of up to £4,800.

Working for Longer?

There has been a rise in the number of people working beyond state pension age. National Statistics say that in the three months to April 2008, over one in nine men over age 65 and women over age 60 were in work. Without adequate pension provision, you might have to join them one day.

IS YOUR WILL A SMART WILL?

Many married couples and registered civil partners will pay less inheritance tax (IHT) as a result of the introduction of the transferable nil rate band, but it is still important to plan to mitigate as much IHT as possible. Remember, the nil rate band is the amount of your estate that is taxed at nil and is currently £312,000; above that point, it is taxed at 40%.

The change means that when one spouse or civil partner dies, his or her nil rate band may be inherited by the survivor, at least to the extent that it has not already been used. The change came in for deaths of survivors after 8 October 2007 who can inherit the unused proportion of their late spouse's or civil partner's nil rate band at the current value.

Following these changes, how you set up your will could have a real effect on maximising the benefits to your dependants.

Until 8 October last year, it was possible for a couple to use both their nil rate bands, but generally only if the first spouse or partner to die passed assets down to the next generation. In many cases, the best way to achieve this was to set up a discretionary trust at the first death, with the survivor as a potential beneficiary and possibly even one of the trustees. There are several advantages to continuing the discretionary will trust approach.

- Increased flexibility – what was appropriate when you made your will might have moved on with changes in the family circumstances or developments in the law or the financial environment. The trustees can react to the new situation.
- A trust may offer a good way to protect the next generation. For example, the trustees can make sure that the children benefit from their parent's estate even if the survivor remarries. They may also be able to provide a degree of protection against the consequences of divorce and separation of any of the beneficiaries of the trust.

This approach may still be worth considering in many situations, even though it is no longer essential for the use of both nil rate bands.

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AN OEIC UNDER THE CHRISTMAS TREE

If you have ever scratched your head in despair about what to give your children or grandchildren for Christmas, then you could consider making an investment for them that will long outlast the Christmas tree. There are a number of different investments that can be made for children which could be useful towards buying a first car or contributing to university costs to stop them getting into debt.

A unit trust, or shares in an open-ended investment company (OEIC), is one option. Any realised gains would be taxed on the child and, of course, he or she would have his or her own capital gains tax annual exemption, which may mean there is actually no tax to pay. Even if there were, under current legislation, the rate would only be 18%. Any income arising through dividends would also be taxed on the child unless the present is from a parent and that 'grossed-up' income (plus the income arising under other gifts from the same parent) exceeded £100.

Alternatively, it could be a good idea to invest in stakeholder pension arrangements for your children or grandchildren. Even if they are non-taxpayers, they are not prevented from obtaining tax relief on the arrangement, so boosting the sum given towards the investment. If you could actually give a reasonably large amount every year, there is the potential to build up a substantial fund to use in the future. Of course, even modest contributions may also reap long-term rewards. Under the current rules children will not normally have access to the funds until they are aged 55 and the way they draw benefits will be subject to HM Revenue & Customs rules at the time.

Other investments which may be worth considering come from National Savings & Investments, or an ordinary bank deposit savings account or, within limits, even one of the friendly society bonds on offer. And don't forget the Child Trust Fund.

As with all gifts, inheritance tax has to be considered, but there are useful exemptions that could well serve to make such gifts worthwhile.

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