Monmouthshire
Independent
Financial
Advisers

Mifa

a Monmouthshire Building Society Group Company

Tax & wealth planning

2009/10

A LIFE OF STAGES, NOT AGES

Shakespeare suggested that there are seven ages of man, but in terms of planning for tax and wealth we can think of our lives in terms of three main stages:

1. **Starting out** This is the initial post-education stage. It marks the first steps in your business, career or professional life. These days the transformation from learning to earning will often begin with a large graduate debt that has to be repaid.

   Although money may be tight – especially with a young family – making the right financial decisions at this stage can lay the foundations for your future prosperity.

2. **Building your wealth** At this stage you should be aiming to accumulate assets for your future. Family responsibilities will usually still be present, but their financing should be less of a drain on your resources.

3. **Preparing for a prosperous retirement** By now the focus is firmly on what happens once work ends and how you can maintain your standard of living in retirement. Family matters revolve around estate and succession planning, but calls for financial help from your children may not completely disappear.

In the following pages we look at the issues that you will encounter over these stages and highlight key questions you should be thinking about as you plan through life.

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Remember…

This publication is for general information only and is not intended to be advice to any specific person. As with all tax planning, you are recommended to seek competent professional advice before taking or refraining from taking any action on the basis of the contents of this publication. The publication represents our understanding of law and HM Revenue & Customs practice as at July 2009.

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FAMILY ISSUES

Protection, protection, protection

Your first priority in financial planning for the family is protection. The aim is to address a variety of 'where would the money come from if...?' questions, such as:

- Where would the money come from if the main breadwinner was unable to work through illness or accident?
- Where would the money come from if you or your partner were to die and the choice was between career and childcare?

Insurance will generally provide the answers, unless you have built up a sufficient capital reserve (which may well need to be greater than you imagine – see the table below).

How much is too much?

The calculation of how much life cover you need is best left to your financial adviser, who can take account of your personal circumstances. However, the amount can be substantial. The table below shows the capital needed today to generate an index-linked income of £30,000 a year, paid monthly, over 20 years at various investment returns, assuming 2.5% inflation or 5% inflation.

Assumed investment return % pa	2.5% Inflation £	5% Inflation £
2	623,109	794,078
3	565,428	714,982
4	515,175	646,420
5	471,243	586,789
6	432,707	534,755
7	398,790	489,199

Trust in trusts

Trusts have an important role to play in family financial planning. Although trusts are commonly considered to be all about tax planning, in practice, outside the tax arena they offer a valuable way to control the use of gifted capital. For example, a trust can

mean the difference between a lump sum windfall for a spendthrift adolescent and a regulated series of payments to cover a student's university costs.

For richer, for poorer...

Divorce or relationship breakdown is inevitably distressing and often costly for both parties. Financial planning is unlikely to be at the forefront of your thoughts at such a stressful time.

However, making the right decisions about when and how to divide assets can be vital to help minimise the inevitable financial disruption. Such judgments call for expert objective advice.

In the long term

We are all living longer. A man aged 40 today has about a 40% chance of reaching age 90, while a woman aged 40 is more likely to reach 90 than not.

A longer life does not necessarily mean a longer healthy life: many of us may end our longer lifespan needing care. The four constituent parts of the UK deal with the care costs in four different ways. For example, in England you will receive no state help for your personal care costs if your capital exceeds £23,000. Any state contribution to your nursing care would be limited to £106.30 a week in 2009/10.

Planning to meet the cost of long term care is therefore an important part of family financial planning.

New income tax rules

From 6 April 2010 if you have total income in excess of £100,000 you will start to lose personal allowance (the amount of income you are allowed to enjoy tax free) at the rate of £1 for every £2 of the excess until the allowance is reduced to zero (probably at around £113,000 in 2010/11).This means that on some of your income you could be paying income tax at an effective rate of 60%.

From the same date, if your relevant income is in excess of £150,000 you will be taxed on the excess at a new higher rate of 50% (42.5% for dividends).

There are actions you may be able to take to reduce these high levels of taxation but you should take professional advice.

Estate planning

If your estate is worth more than the 'nil rate band' of £325,000 (in 2009/10), it could be subject to inheritance tax (IHT). There has been a variety of complex changes to the IHT rules in the last few years, some of which may have rendered any earlier IHT planning you made counter-productive.

Fortunately the worst effects of IHT can be mitigated with sound long term planning, the starting point for which is usually an up-to-date will.

For individuals who die on or after 9 October 2007 it is possible to utilise the percentage of any unused 'nil rate band' of a previously deceased spouse or civil partner, whenever the latter individual died. This provision may mean that you specifically need to review your will urgently.

There are a number of actions that can be taken in lifetime to ensure that IHT does not have such a big impact on your estate than it might otherwise. Lifetime gifting is invariably involved and this may be done by using of one or more of the plans issued by life insurance companies.

BUSINESS PLANNING

The right structure

If you want to start your own business, you have a choice of four main structures:

- Sole Trader – working on your own account
- Partnership – working with one or more partners, possibly your spouse.
- Limited Liability Partnership (LLP) – a halfway house between a partnership and a limited company.
- Limited company – working as a director, either alone or with others.

Each structure has its own advantages and disadvantages. None should be taken as a permanent choice: traditionally it has made sense to switch from sole trader or partnership to limited company as profits rise.

Where's the money coming from?

Your business will need finance, whether it is a start up or an existing enterprise. You may be able to provide this from your personal resources, but more often than not some external funding will be required.

Once upon a time this used to mean your bank, but now there is a wide range of options. The greater choice means more factors to consider, including:

- Would private equity be a better alternative than borrowing for the capital you require?
- Could your pension plans be used to provide or repay finance?
- What is the most tax-efficient way to borrow?

It's all mine

Who owns what share of a business can be an important factor in your overall financial planning. For instance, placing shares in trust for your children may be a wise move for estate planning purposes if your company grows strongly.

Dividing ownership with your spouse or partner may save income tax, but this is an area that needs great care.

A painless extraction

If your company is profitable, then there are a variety of ways to extract your profits. The most obvious – paying yourself more salary or a bonus – will usually be the most expensive in terms of tax and national insurance contributions.

For now dividends are generally the most attractive option if you need cash, but a pension contribution may be the better means of extraction for the long term.

A bonus or a dividend?

Ann wants to extract £20,000 of gross profit from her company. She is a 40% taxpayer and her company pays corporation tax at a rate of 21%. From a tax viewpoint, her choice is shown below:

	Dividend £	**Salary £**
Gross profit	20,000	20,000
Corporation tax	(4,200)	N/A
Employer national insurance	N/A	(2,270)
Payment to Ann	15,800	17,730
Employee national insurance	N/A	177
Income tax	(3,950)	(7,092)
Net cash	11,850	10,461

Who's next?

Succession planning should be a key consideration for any business. In a family enterprise, succession planning can have two levels:

- Who are the successors to key employees?
- How and when will ownership of the business pass to the next generation?

Current tax rules favour the older generation holding onto the business until death, but other factors – and the younger generation – will frequently favour an earlier transfer.

INVESTMENT

Risk and reward – the two 'R's

The ideal investment is one that gives you a rising income, guarantees a capital return that outpaces inflation and that can be cashed in at any time. However, if you are ever offered such an investment you should be on your guard: no such ideal investment exists.

In the real world, investment is a compromise between risk and reward:

- The safest investments – government bills and bonds – offer relatively low returns. For example, long term index-linked gilts held to maturity will currently guarantee you a pre-tax return of around 1% pa above inflation.
- The most risky investments, such as certain derivative contracts, can expose you to both substantial returns and unlimited losses.

For each investment that you make, you and your financial adviser need to decide the balance of risk and reward that is appropriate. This is likely to vary according to the purpose of the investment. An investment for a pension, for example, that will not be drawn on for 20 years or more will usually be more adventurous than one designed to meet school fees in three years' time.

Risk and reward

One way to examine the risk/reward balance is to look at the long term investment statistics from Barclays Capital Equity Gilt Study. The table below shows the inflation-adjusted average annual return (including reinvested gross income) over various periods to the end of 2008. It also shows the worst single year's performance over each period.

	UK equities		UK government bonds		Deposits	
Term years	Return % pa	Worst year	Return % pa	Worst year	Return % pa	Worst year
5	0.2	-30.5	3.5	-4.4	0.6	-0.2
10	-1.5	-30.5	2.4	-5.2	1.4	-0.2
15	2.2	-30.5	4.2	-13.8	1.3	-0.5
20	4.6	-30.5	5.6	-13.8	1.9	-0.5

The tax tail and the investment dog

Tax and investment are inextricably linked: what matters to you as an investor is your net return, after the government has taken its slice of income and gains.

Important though tax is, it should not be the prime motivator of any investment decision. The process ought to be to:

1. Decide on the investment, then
2. Select the appropriate structure for that investment.

For instance, if you wanted to invest in UK commercial property, you could choose to buy shares in a real estate investment trust (REIT) because of its favourable internal tax treatment (gains and rental income within a REIT are tax free – all tax liability falls on the investor). This would usually be preferable to, for example, a life assurance-linked bond where two layers of tax could apply.

Unfortunately some investment decisions start from the tax end – typically because there is up front tax relief. The tax incentives are heavily promoted and the investment aspect played down. Some investors in tax-driven schemes have learned the hard way that a taxable profit is preferable to a tax-efficient loss.

BUILDING UP A RETIREMENT FUND

Anything but a pension?

Pensions have not enjoyed the best of press over recent years. Nevertheless, a pension plan can still be the right structure if you are making investments for your retirement, but the pros and cons are more balanced than they once were:

For	Against
Contributions (personal and employer) normally attract full tax relief, but restrictions may apply if your income is £150,000 or more	Exceeding allowances attracts penal taxation. You might be taxed at a higher rate on the benefits from the tax relief you received on the contribution
Funds generally grow free of UK taxes	There is no tax reclaim on UK dividends, so there can be double tax
25% of the fund can usually be drawn as a tax-free lump sum	75% of the fund has to provide a fully taxable retirement income
A pension is a dedicated retirement planning vehicle	Benefits cannot be drawn before age 55 (50 before 6 April 2010)
Can help with business finance	Conditions for loans are strict, eg maximum initial term less than five years. Not available to self-employed
Normally protected from creditors	Prone to changes of rules by governments
Your employer may meet a large part of the cost	But not if you are self-employed

The contribution conundrum

Changes introduced to the pension contribution rules in April 2006 now mean that, in theory, often the decision to fund a pension can be left until less than ten years before retirement. For example, you

could choose to invest elsewhere until your early 50s, thereby retaining access to your funds and then start transferring your investments into a pension plan in the run up to retirement.

In most cases, the maximum tax-efficient pension contribution that an employer could make on your behalf in 2009/10 is £245,000. You can personally contribute up to 100% of your earnings, but the £245,000 ceiling applies to the total of contributions from all sources. The theoretical contribution ceiling rises to £255,000 for 2010/11 after which it is frozen until at least 2016/17.

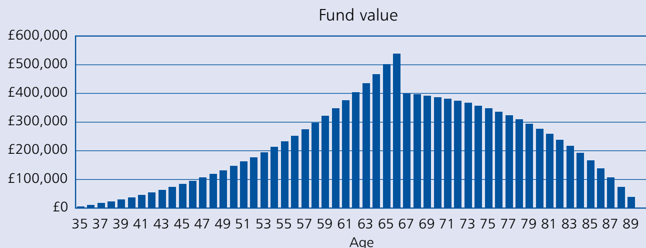
However, new rules which potentially restrict tax relief on contributions if you have income of £150,000 or more can make pension contributions unattractive, even within the £245,000 limit.

In practice, delaying the start of pension planning can be a dangerous strategy because:

- The contribution rules could change again. The most recent changes may not be the last restrictions applied to tax relief.
- Your planned retirement date may have to be brought forward because of redundancy, illness or some other reason.
- You (and/or your employer) may not have the resources to make the necessary contributions over a relatively short period.

What goes up...

Jill starts saving for her retirement today at age 35 with an annual investment of £5,000 a year. She increases this each year in line with inflation (at 2.5%) and earns a return of 5%, net of all charges. At age 67 (her state pension age) she draws 25% of her fund as cash and uses the balance to provide an inflation-proofed income until she dies at age 90 with nothing left of her investment. The profile of her investment looks like this:



PLANNING AT RETIREMENT

Decisions, decisions

The decisions that you take as you approach retirement will potentially affect the rest of your life. Make the wrong choice with your pension arrangements and you could spend many years of leisure regretting your error. The risk of a mistake is exacerbated by the increasing range of options now available.

Bang or whimper?

The first decision you need to make is whether to stop work completely or, if you have the option, phase in your retirement. The gradualist strategy can be beneficial, particularly if your retirement resources are not as large as you might like. However, not all pension arrangements can cope with the incremental approach to drawing benefits.

Tax-free cash – is it worth it?

The tax-free lump sum from any of your pension arrangements will usually be 25% of the total value of retirement benefits, although you might qualify for a higher percentage under special transitional rules introduced in 2006.

Be warned if, like most people, you are lured by that magic phrase 'tax-free'. From a strict financial viewpoint, it may not be worth taking the maximum available cash, even if it is 'tax-free'. You will generally have to exchange some of your pension entitlement for the cash if you are a member of a private sector final salary (defined benefit) pension scheme. The terms of this swap, technically a pension commutation, are set by your pension scheme and may not reflect the market value of the pension forgone (see example overleaf).

On the other hand, if you are not a final salary scheme member, taking the maximum cash is normally the right thing to do – provided it is invested wisely.

Tax-free, but...

John's final salary pension scheme offered him the following choice on his retirement at age 63:

- a pension of £23,486 a year, increasing in line with inflation up to a maximum of 5% a year

Or

- a pension of £15,097, increasing in the same way.

Plus

A tax-free lump sum of £100,668.

John would therefore lose £8,389 a year of his scheme pension, but his lump sum would only buy an equivalent pension annuity of around £4,100 a year.

Your retirement income options

Once it was so easy: either your employer's scheme paid you a pension or you had to buy an annuity with your pension pot. Now your options are much greater. For example, you may be able to:

- Leave your pension fund invested and make regular withdrawals from it.
- Draw your retirement 'income' as a combination of tax-free cash and annuity payments.
- Take no immediate income but draw your tax-free cash in full.
- Buy an 'enhanced' annuity which takes account of your lifestyle or medical history.

Flexibility can be built in, both in terms of varying the income to suit your needs and providing benefits for your dependants.

Somewhat inevitably, more choice means more complexity. You should now always take independent professional advice before converting your pension fund into retirement income.

SELLING THE BUSINESS

The right time

If you were selling your home, you would probably make sure that it gave a good initial impression to potential buyers. Most likely you would also aim to sell when property market conditions favoured sellers over buyers.

When it comes to selling your business, similar principles apply. You will want your business to appeal to would-be purchasers with:

- A pattern of rising profits.
- Solid finances with readily manageable borrowings.
- A stable workforce.
- Good prospects for future returns.

Ideally those features will coalesce at a time when market conditions for business sales are good. One major consequence is that you need to start planning for a business disposal long before the 'for sale' board goes up. In fact, there is a case for saying that if a sale is your ultimate goal, then your preparations should start when the business begins.

The right price

What is your business worth?

That simple-looking question can be very difficult to answer. If you are selling your home, you can get a good idea of its value by looking at the prices of similar properties in your area that are on the market. There are no such readily available comparative data for privately owned businesses. Transactions are usually kept under wraps, with only the parties involved and their advisers aware of the details.

As a result, it is vital that you seek professional advice about selling your business. Experts in

the field will not reveal what was paid for other business sales in which they have been involved, but they will use that knowledge to put a realistic valuation on your business.

They can also help with the sale negotiations. Buyers will also usually be relying on professionals, for example to carry out due diligence, and you would be at a disadvantage if you did not have similar support.

The right tax

How and when you sell your business can determine the amount of tax you eventually have to pay. For example:

- If you are self-employed with a year end date of 30 April, selling in March means that you will have 23 months of profits taxable in one tax year.
- If you have a company, it will usually be better to leave cash in the business and demand a higher price rather than to pay yourself a final dividend (although too much cash kept in the business could result in a loss of capital gains tax entrepreneurs' relief).
- A buyer may want your business, but not the company that owns it. Such a deal involves two potential layers of tax on gains – one in the company and the other in your hands.

Retaining the business property

Harold sold his company in May 2009, claiming entrepreneurs' relief on £500,000 of the gain. He retained the property from which the business operated and charged its new owners rent. Two years later the business failed, leaving Harold with an empty property. After trying and failing to let it for six months, it took another nine months before Harold managed to sell it for the price he wanted. Several earlier and lower offers were refused.

Harold was unable to claim any of his remaining £500,000 entrepreneurs' relief on the property gains because the sale took place more than three years after he had sold his business. The earlier offers may have been lower, but the tax saving would have more than compensated for the reduced price.

OVERSEAS ISSUES

Leaving the UK

Are you planning to go abroad to work or retire?

Moving between countries can be a tortuous exercise, with a wide variety of issues for you to deal with, from foreign driving licences to UK pet passports. At such a time, financial planning may be relegated to the 'do-when-we're-there' list. It should not be, because by then opportunities to save tax may have been permanently lost.

The departure checklist

- ☐ What is the best time from a tax viewpoint to leave the current home and/or become resident in the new country?
- ☐ Should any transfers between spouses or gifts be made before departure?
- ☐ Should existing investments be retained, sold now, sold later or restructured, eg placed in trust?
- ☐ When should bank accounts be opened/closed?
- ☐ How should any new home be owned?
- ☐ Has all the tax paperwork – both UK and overseas – been dealt with?
- ☐ What amendments should be made to existing life and health cover?
- ☐ How can tax liabilities in the new home country be minimised?
- ☐ Are new wills required?

Coming to the UK

There are two distinct areas of financial planning for new UK arrivals:

1. **Foreign nationals** If your roots are outside the UK, then the questions in the departure checklist (see above) will equally apply to you. In April 2008 radical changes were made to the UK rules for taxing many foreign nationals resident in the UK.

The UK is no longer the tax haven it once was for non-UK individuals, but there are still ways to reduce your UK tax bills, provided the right structures are in place before you arrive.

2. **UK nationals** If you are returning to the UK, then once again the departure checklist is your starting point. As a UK national you will probably not be able to take advantage of any non-domicile tax planning, but it is still important to review investments before your UK arrival. This can produce some surprises – for example with CGT at a flat 18% in the UK, it may now be worth not realising gains before resuming UK tax residence.

Staying in the UK

If you are a foreign national living in the UK then, as mentioned above, the UK tax rules for you changed from April 2008. If you have not reviewed your financial planning in the light of these changes, it is vital that you do so as soon as possible. If you have been tax resident in the UK for seven or more of the last nine tax years, then in 2009/10 you may have to pay UK tax on all your overseas income and capital gains, even if they are not brought into this country. Alternatively, you could pay a flat annual tax charge of £30,000.

WHAT TO DO NEXT

A brochure this size can barely touch the many aspects of tax and wealth planning. Nor is it designed to replace serious advice in such a complex area.

If anything you have read has struck a chord, just thinking 'I must do something about that later' won't really help you. As a general rule, the sooner you start reviewing a particular issue, the more scope you have for effective action. Last minute planning – if possible – rarely provides an ideal solution.

Your next step should be to talk to us. Make some brief notes to record the areas you think you should review and get in touch. We can give you expert advice and guidance which draws on our broad experience, but is specific to your personal circumstances.

Monmouthshire Independent Financial Advisers are part of the Monmouthshire Building Society Group and were established in 1997 to offer our customers access to independent financial advice. Our experienced financial advisers are qualified to deal with your enquiry impartially, and as independent financial advisers we are able to search the whole of the marketplace to find the products most suited to your needs.

We can offer you advice on:

- Inheritance tax planning
- Investments
- Corporate & personal pensions
- Long term care
- Key man and shareholder protection
- Income protection
- Retirement planning
- Residential and commercial mortgages
- Lifetime mortgages
- School/university fee planning

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