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What you can learn from past performance

‘What return will I get from my investment?’

It sounds a simple enough question and it is one financial advisers are asked every day. Unfortunately there is no real answer. For example, if you put cash in a typical deposit account, the interest rate could change at any time. Even if you choose a fixed rate, fixed term deposit, your overall return is still not completely certain. Tax levels could alter and so could inflation, both of which would affect the buying power of your investment when it reaches its maturity date.

There are greater uncertainties

outside the world of deposits. The value of investments in shares or bonds can fluctuate – as has happened over the last six years – and you might not get back a significant proportion of your investment. However, you should not place any great reliance on what has happened since the turn of this century: as the investment advertisements regularly remind us, past performance is not an indication of future performance and may not be repeated.

In spite of the unreliability of the past performance crystal ball, investment experts still spend a considerable amount of time and computing resource on looking at

what has gone before. The classic example of such research is the Barclays Capital Equity Gilt Study, which in one form or another has been published annually since 1956. The 2006 Equity Gilt Study provides a mine of information on the annual returns of UK shares, government bonds (gilts) and sterling deposits from the beginning of the 20th century.

The study’s long term results paint an interesting picture. Over the last 10, 20 and 30 years to the end of 2005, UK shares have outpaced cash deposits based on pre-tax returns. However, in the last ten years, government bonds beat UK equities, as did 15-year

corporate bonds. Not surprisingly, over the five years from December 31 2000, UK shares were the worst performer.

Although the weight of past statistics cannot tell you what next year’s results will look like, they do give a historical justification for one important principle: the diversification of investments. As the data shows, there has been no one category that turns up trumps every year. The investor who chose a long term mix of cash, bonds and equities will generally have had a smoother ride than the pure equity investor and usually have beaten the returns from holding only cash.

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Tax changes impact on wills and trusts



Many thousands of people may need to revisit their wills and inheritance tax plans following the surprise tax changes announced in this year’s Budget. The changes introduce an inheritance tax charge on assets gifted into most kinds of trust, affecting both new gifts and many

existing arrangements. For most people the impact is likely to be very little, but if you have a large estate, the consequences could turn out to be considerable.

The new rules only affect trusts – the legal devices that allow you to make gifts for the benefit of your children or other beneficiaries, with the assets held by the trustees you choose.

In effect, the Finance Bill 2006 rewrites the inheritance tax rules for the two most popular forms of trusts used in estate and other financial planning arrangements: flexible trusts (which are a form of ‘interest in possession’ trusts) and accumulation and maintenance trusts.

The effect of the proposed new rules is that almost all new

gifts into trusts could suffer inheritance tax at 20% of their value to the extent that they exceed the donor’s unused nil rate band – which could be up to £285,000 this year. Then there will be a tax charge of up to 6% of the trust’s value every ten years, usually to the extent that assets in trust are worth more than the nil rate band. And there will be a proportionate charge when assets leave the trust.

Most trusts are below the nil rate band or not much above it, so there will be little or no ten yearly or proportionate tax charges. But the extra layer of complexity and the long-term impact on larger trusts could be significant.

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Retirement income options now



alternatives can offer you potentially more income, they do not normally have any guarantees: your income could fall as well as rise.

If you choose a traditional annuity, you should never accept what your pension provider offers without first checking with us what annuity rates are available in the

marketplace. The difference between the best and worst rates in the market can be substantial.

There are also now a small number of investment linked annuities. With these, you choose an assumed return for the investments underlying the annuity (between 0% and 5%) and this determines your initial level of income. Your subsequent income will depend on how the investments perform in relation to that assumed return.

If you are relatively cautious about how fast you think the underlying investments will grow in the future, you will start off with a low income, but with a higher probability that it will

grow in the long term. But if you are reasonably optimistic in your assumptions, your initial income could be higher, with the possible danger that it will not increase and may even fall in the future.

■ **Pension fund withdrawal**
Your income is provided by making regular withdrawals from your pension fund (sometimes also called income drawdown or, under the new pension regime, unsecured income). The new tax rules mean that you are no longer required to buy an annuity by age 75 if you choose pension fund withdrawal. Instead you can continue withdrawals as unsecured income in the more restrictive form of an alternatively secured pension (ASP).

If you were to die before reaching the age of 75, the remaining withdrawal fund can generally be paid to your beneficiaries free of inheritance tax. If you opt for ASP at age 75, there are no lump sum death benefits, other than the option of a tax-free payment to your nominated charity. If you have dependants, in the first instance your remaining fund must be used to provide income benefits for them. If you have no dependants (or on their

subsequent death) the residual fund can be transferred to the fund of another member of your pension scheme (eg a grandchild), but this would be liable to inheritance tax.

■ **Phased retirement**
If you do need your tax-free cash for a specific purpose, eg repaying loans, you could consider phased retirement. Under this option, each year (up until age 75 at the latest), you use part of your pension fund to provide:

- a tax-free lump sum, and
- either buy an annuity or take a pension fund withdrawal.

Your retirement 'income' is the combination of the lump sum and the taxable annuity or withdrawal payments. Normally this process means that there is little income tax liability in the early years, as most of your 'income' is actually tax-free cash.

You should only consider phased retirement, pension fund withdrawals (including ASP) or investment linked annuities if you can afford to see your retirement income fluctuate. For example you might have another major source of income.

If you are due to retire shortly, you should be among the first to benefit from the new rules for pension income benefits introduced on 6 April 2006. So if you are a member of an executive pension plan, personal pension plan or retirement annuity, you have three main options (these are just for information and you should take independent advice before acting):

■ **Purchase an annuity**
Rates may be at historically low levels, but annuities should not be dismissed without careful thought. The traditional annuity has one very important advantage: it will give you a guaranteed gross income for as long as you live. While the

What base rate cut?

A number of banks and building societies have been quietly cutting their deposit interest rates, even though the last reduction in the Bank of England base rate was in August 2005. These cuts, which are sometimes justified as a response to market conditions, could well be followed by further reductions should the Bank decide to nudge the base rate down later in the year.

With interest rates at relatively low levels, a seemingly small snip of 0.2% from the rate can add up to a painful cut in your overall interest income. But the other result is a correspondingly useful increase in profit margins for the bank or building society, so you should not expect the trend to be reversed.

If you depend on your investment income, there are still some attractive income investments around, provided you are willing to look beyond short term deposits. However, unlike

deposits, which are secure, the value of shares and other investments can fluctuate and it is possible you might not get back a significant proportion of your original investment. Past performance is not a guide to future performance and may not be repeated.

Below is some information about current income-oriented investments, but you should take independent advice before taking any action.

■ **UK equity income funds**
Although the value of UK shares has been rising for some time, their income yield remains attractive relative to deposit rates. The reason for this is strong dividend growth: in the year to the end of March 2006, average dividends rose by nearly 17%. Investment in UK equity income funds can offer you a good income now with potential for long term growth both in

your income and capital values. However, as with any share-based investment, income and capital values could fall.

■ **Overseas equity income funds**
A handful of income funds investing in overseas markets have recently been launched. These can provide you with some worthwhile diversification alongside the large number of UK equity income funds. Exchange rates may cause the value of these funds and the income from them to fluctuate.

■ **Corporate bond funds**
Yields on corporate bonds have changed little over the last year. As a result, many corporate bond funds still offer higher income yields than deposit accounts – yields that do not change in response to moves in base rates. But do not forget that your capital is at risk in corporate bond funds. One important tax advantage of these funds is that you can invest in them via ISAs

and PEPs, which means you receive your fund income free of UK tax. Remember tax rules can change in the future.

■ **Guaranteed income bonds**
If you are a higher rate taxpayer and are prepared to accept little or no access to your capital during the fixed term of several years, guaranteed income bonds can be worth considering. These can provide monthly or annual payments, but under the current tax rules all your income tax liability will generally be postponed until the date the bond matures.

At that point, if you are a higher rate taxpayer you only pay additional tax (at 20%) on the total net overall return – the total amount you have got back including the monthly/annual regular payments less the amount you invested. With a deposit account, your extra tax is based on the gross interest.

Now with added tax relief...



A brighter option on life cover

The Chancellor has potentially cut the cost of new life cover at a stroke by allowing full tax relief on the premiums. So you could benefit from a discount of up to 40% (22% if you are a basic rate taxpayer) on the cost of certain kinds of life cover.

What has happened is not quite as strange as it may at first seem. The change in the tax rules only applies to term assurance cover taken out under pension plan rules. You can take out this type of cover separately from your pension retirement savings plan.

Tax relief does not apply to ordinary life cover. There has been full income tax relief on premiums to pension term assurance (PTA) policies for a long time. But until this April, the

rules were very restrictive and it was typically not a viable option for most people. Since A-day, all that has changed.

The amount of cover you can now arrange under pension plan rules is huge. Under the new rules, your pension arrangements can, in total, provide a lump sum on death of up to £1,500,000 – that is, the amount of the standard lifetime allowance in 2006/07 – and it will be more in later years. This possibility ceases when you reach the age of 75 and there are different rules for the death benefits of pension arrangements where you have started to draw the retirement benefits.

What is more, the amount you can spend on pension term

assurance has increased very substantially. Your overall maximum tax-relievable personal contribution to all pension arrangements is normally 100% of your earnings.

Even if you have no earnings whatsoever, you can contribute up to £3,600 a year before tax relief and get at least 22% tax relief. If you are not saving for retirement, the whole of your contribution can be used for life cover.

These two limits will probably mean that you have scope to use PTA to increase your life cover significantly. You could also replace your existing life assurance policies with PTA, thereby gaining income tax relief on premiums.

This substitution option has obvious appeal and has even attracted some direct mail advertising. However, it needs to be handled with some care. It is not a simple question of cancelling your old life policies and then filling out the form for a new PTA policy:

- You should *never* cancel any cover until the new cover is in place. If you do, you could leave your family exposed during a period when you have no life cover. Worse still, you might find the terms of your new cover are less attractive than its predecessor.

- PTA cannot run beyond age 75, so it is of limited value for long-term inheritance tax cover,

although it can be useful for covering the temporary liability on lifetime gifts.

- The PTA rules mean that the cover provided is basic. For example, many life term policies incorporate a terminal illness benefit, which means the policy pays out if you are diagnosed as having less than one year to live. PTA does not include this.

- The very few people who have accrued substantial retirement benefits and have or will preserve them under the special A-day transitional reliefs should not take out this type of cover. This is just another reason why it makes sense to get competent advice – even about something as apparently straightforward as life assurance cover.

- The premium savings may not turn out to be as great as you expect. For a variety of reasons, the PTA premiums before tax relief may be *higher* than your current premiums. The overall saving could therefore be small, particularly if you are a basic rate taxpayer. It is also worth bearing in mind that the tax rules could change again at some point in the future.

Life cover is one of the basic financial planning building blocks for most people. The opportunity to buy this essential insurance product with the benefit of tax relief is very good news. It makes sense to undertake a review of your life assurance needs and solutions now.

The new pension investment rules

Pensions have been hugely liberated by the new rules that came in on A-day – 6 April this year – making self-invested personal pensions (SIPPs) the vehicle of choice for many investors.

SIPPs have become even more attractive than they were in the past because you can generally invest far more into them each year and scope for investment is wider. These plans are not right for everyone.

It is important to make sure you choose the right kind of SIPP and it is therefore essential to get competent and unbiased advice.

Her Majesty's Revenue & Customs (HMRC) has published detailed draft new rules on how you can invest your pension fund. If there are no further changes, the position (retrospective to 6 April 2006) will be:

- Investing directly in residential property will generally be subject to penal taxation. However, it will be possible to make indirect investments in residential property tax-efficiently via real estate investment trusts (REITs), when these become available during next year.

- Your self-invested pension scheme will be able to borrow up

to 50% of the net value of the fund *for any purpose*. The old rules restricted self-invested personal pension borrowing purely to the financing of commercial property purchase.

Virtually all pension providers have radically revised their pension offerings to take account of these investment revisions and the many other changes introduced on A-day. The new generation of self-invested pensions offers you a very wide investment choice, with much greater scope for



contributions than was possible under the old rules.

Why not employ your partner?



Your special employee's pay is treated as their personal earnings for tax purposes, which might mean it escapes liability altogether, if the level is low enough.

For example, if you gave your family employee a salary of £5,028 a year

(£419 a month), neither of you would normally have any NICs to pay on this wage, because the NICs starting point is just £420 a month. If your employee had no other earnings, their salary would be covered by their personal allowance (£5,035 in 2006/07) and so would be free of tax.

If you are a self-employed higher rate taxpayer, your joint total savings could be £2,061, as shown in the table.

The benefits do not end there, thanks to the government's wish

If you are in business on your own account, employing your spouse or partner can be a highly tax-efficient way of using some of your profits. Indeed, the government has almost gone out of its way to encourage this type of family employment.

Your new employee's pay will be allowable against your business profits, provided the employment is genuine and the salary justifiable. So you save income tax and national insurance contributions (NICs) – a total reduction of up to 41% of pay.

to see adequate pension provision for the lowly paid:

■ Provided your employee is under state pension age, they will receive credits for the basic state pension and earn benefits under the State Second Pension Scheme (S2P), even though no NICs will be paid. A year's membership of S2P is currently worth at least £66 a year in index-linked pension from state pension age.

■ You can add a pension plan to your employee's remuneration package and receive full tax relief on the contributions (and reduce your NICs bill further). In theory, under the new pensions regime,

you *could* contribute up to the annual allowance of £215,000, but such generosity is highly unlikely to be agreed by your tax inspector. It is much wiser to make a modest contribution. In the past, the chosen figure has been £3,600, the normal tax relievable personal contribution limit for non-earners.

Similar benefits are available if you operate through a company rather than on a self-employed basis. In an environment where there are increasing constraints on tax planning, employing your spouse or partner is one option you should not miss.

| Profits/salary paid to: | Self £ | Employee £ |
|--------------------------------|--------------|---------------|
| Profits/salary | 5,028 | 5,028 |
| Less: Income Tax @ 40% | (2,011) | Nil |
| National Insurance @ 1% | (50) | Nil |
| Net Income | 2,967 | 5,028 |

Tax changes impact on wills and trusts

Continued from front page



Right now there is considerable uncertainty about the full effect of the draft legislation on new and existing trusts.

There could still be some changes in response to the widespread criticism which the measure has provoked. Remember that the Financial Services Authority does not regulate will writing and taxation

and trust advice. But even now, three things are clear:

■ The government is adopting an ever harder line on inheritance tax, which is expected to raise £3.6bn in 2006/07. The adjustments made to the nil rate band – which do little more than counter inflation – suggest that the subject of reform has been kicked into the long grass

until after the next election.

■ If you have any existing inheritance tax planning in place (including your will), it ought to be reviewed as soon as possible once the dust has settled. It may turn out that nothing needs to be altered, but only a thorough review will reveal the right course of action.

■ If your estate is worth, or is likely to become worth, more than the nil rate band, and you have not undertaken any inheritance tax planning, you need to act. Once again, the timing for review will depend on the finalisation of the legislation.

Despite the uncertainty, inheritance tax planning will still be very worthwhile. A range of powerful strategies remain to ensure that as much as possible of your estate will stay in your family after your death.

With profits reassessment?

The strong stockmarket performance of 2005 meant that in the early months of this year, some life companies reduced the market value reduction factors for their with profits policies (and hence increased surrender values), even if they did not increase bonus rates. So, now is a good time to review whether to keep the policies or reinvest elsewhere.

Beware the A-day bulletin

Have you received a bulletin from your pension providers about A-day changes? If it doesn't make much sense – and some of them are far from comprehensible – we can translate the pension speak into plain English. Don't just ignore it as more red tape – the changes that are being made could alter your retirement plans.