AF5 October 2019 notes

Simon and Grace are both 45 and married. They have two children who are likely to be in higher education over the next 5 years.

Simon has a salary of £54, 000 and Grace £36,000. They also have joint savings income of £806. Simon receives £12,000 in dividends from his business together with £1,950 from individual share holdings. They also have a joint dividend of £5,625, a total household income of £110,381

Outgoings are £65,000 which includes a payment of £1,000 a month to support their eldest child through university.

Whilst they have a good income and Savings and Investments of £618,000 there are significant weaknesses in their financial situation.

They have no life protection other than Grace's DIS of £108,000 and Simon's ASU policy
Their repayment mortgage of £275,000 runs to 2043 but they want to retire in 2034
They have made very little pension provision
They are also facing 5 years of additional expenditure as they support their children through university

Possible Objectives

<u>Immediate Objectives</u>

- To review the suitability of Simon and Grace's current savings and investments
- To establish a strategy to pay for their higher education costs
- To ensure that they are financially protected in the event of death or long term illness

<u>Longer term objectives</u>

- To ensure their mortgage is paid off by retirement/at 60
- To ensure they have sufficient income in retirement

IHT/estate planning has not been shown as an objective. There does not seem to be an immediate need but candidates might want to review the basics and then should be able to cope with any question.

The objectives are simply an "educated guess". Make sure you read the actual objectives in the exam.

Current savings and investments

General comment (possible factors question)

- They have used their ISA allowances in the past years but not made any contributions in the current years
- Grace's ISA matches her needs for Ethical Funds
- Too much amount on deposit which doesn't produce much interest
- Interest from their deposit account is all within their PSA but Grace has not used her full £1,000
- Premium Bonds are low risk, produce no income but offer tax free prizes
- We don't know the underlying funds in Global Growth nor the charges.
- Is asset split suitable for their different ATR
- No Gilt/Bond exposure
- No property/commodities
- They seem to have Global diversification through the OEICs
- The offshore bond is earmarked to fund higher education
- We know nothing about individual company shares.
- Both using £2,000 dividend allowance
- Amount in OEICS is above the FSCS compensation limit.

Identify the additional information you would require from Simon and Grace to give them advice on the suitability of the non-pension savings and investments.

- Objectives/income/capital required/timeframe/earmarked for specific purposes
- Emergency Fund required
- Details of individual company shares
- Asset allocation in the Global Growth Funds/Funds in this OEIC
- Willingness to switch or sell
- Fund performance of the two ISAs
- Charges
- On a platform or held directly
- Base cost of ISAs
- Use of CGT allowance/any previous losses that can be carried forward
- Capacity for loss

How to improve tax efficiency

- They should utilise this year's ISA allowance
- Sell sufficient of their Global Growth Fund to make gain of £24,000 (£12,000 each) then reinvest in an ISA. Repeat next year
- Any remaining after disposal and reinvestment into ISA should be in Grace's name. This would not incur CGT

- It enables Graceto make full use of her dividend allowance and as she will pay tax at 7.5% rather than 32.5%
- Encash some of the OEICs to invest into their pensions
- Simon to purchase £10,000 more Premium Bonds
- Simon to invest in an EIS

EIS technical

- 30% income tax relief on investment
- But limited to Simon's income tax liability
- He could carry back and use last year's allowance
- Relief clawed back if disposed of within three years
- Can use CGT deferral
- CGT after three years
- Losses can be offset against income
- Suitable as he is a high risk investor
- Needs to bear in mind the these are shares in unlisted companies
- So may be significant liquidity issues
- They have extensive other assets so probably a higher capacity for loss

It's also possible that you might be asked the same question about a SEIS or VCT

Comment of the suitability of Simon retaining the Premium Bonds.

- Being NS & I product is guaranteed by the Govt
- No interest paid to savers but put into a prize fund and monthly prizes from £25 to £1 million. Interesr rate is 1.4%
- All prizes tax free therefore appropriate for Simon as a higher rate tax payer.
- Does not need to entered on tax return
- With £40,000 holding, probability of winning at least one/two prize a year
- Can get original investment back on demand but would have forgone the interest he would have earned.
- Having inherited them there is no specific reason why they should be cashed in, Simon should probably keep these.
- Could consider buying another £10,000 to get to the maximum and increase his chances of winning.

Individual company shares

<u>Additional information question</u>

- What company shares are in his portfolio?
- How many companies does he own?

- Individual performance both growth and dividend/Base cost/Current price/Dividend performance per share
- Why were these selected
- Is Simon still looking to purchase further direct shares
- Any strategy in their selection
- Has any bench mark been selected
- Future plans for the shares
- Any shareholder benefits

Pro's and cons of holding shares individually compared to a pooled investment

Pros

- No ongoing fund charges
- Simon has direct control/easier track
- May get additional benefits
- He gets a vote at the company's AGM
- Sales can be targeted to use CGT exemption

Cons

- Lack of diversification
- Increased non-systematic risk
- May be in a restricted number of sectors
- May not be negatively correlated
- No benchmark selected
- Does he have knowledge, experience or time to manage this portfolio
- No review of the portfolio has taken place
- No rebalancing
- CGT allowance hasn't been used
- More difficult to put into an ISA
- Business of the company may have changed through the years
- Being certificated rather than electronic (CREST) it requires a stockbroker's account and will take longer, possibly higher charges to sell
- If certificate lost can be difficult to sell

Grace's Ethical Investments (possible comment question)

- More limited number securities to select if on a negative basis
- She is avoiding potentially very profitable companies
- The criteria can be subjective
- Research into this adds to the costs
- Positive screening approach will tend to mean investing in smaller companies

- Therefore risk increases
- May be difficult to benchmark

To establish a strategy to pay for their higher education costs

What factors would you consider in drawing up a strategy?

- How much will cost be/how much are you willing to give your children
- Money needed immediately and then for next five years with double the cost in 21/22
- Inflation factors
- Simon and Grace have the resources to pay these
- The Investment Bond was earmarked to pay for these.
- Will both children continue to take out student loans for their tuition fees?
- Not eligible for a loan to pay maintenance costs due to parent's income
- Any bursaries/scholarships available/courses longer than 3 years
- Will you expect the children to contribute e.g vacation work, part time work?
- Would other relatives be willing to contribute?
- Likelihood of further post graduate education
- They may be willing to repay their student loans?
- Where would the money come from
- Potential earnings once graduated
- Protection needed for future costs

Student loans explainer

- Loans can be taken out to cover tuition fees and maintenance
- In view of parent's income will probably only qualify for tuition loan
- Interest is charged whilst studying at RPI
- Once in work interest rate is RPI + x%. The higher the earnings the greater is x
- Graduates only start to become liable in the April after they leave university and only if their earnings are more than £25,725 (this is increased each year)
- They are not strictly loan repayments as a flat 9% surcharge on income tax rate is paid regardless of the amount of the debt.
- Therefore paying off debt does not reduce monthly payments
- It is effectively a Graduate Tax and collected through PAYE
- The loan is wiped out after 30 years
- But having an outstanding debt would have a negative impact on borrowing ability.

For more detailed information see

https://www.moneysavingexpert.com/students/repay-post-2012-student-loan/

Explain in detail how the offshore bond could be used to fund higher education costs

- They could use the 5% withdrawal £2,750 tax deferred
- Immediate withdrawal 6 x £16,500
- Annual maximum does not meet income needs and excess would be taxed. Half on Simon @ 40%, half on Grace @ 20%
- But when bond finally surrendered, 5% withdrawals are added back and Simon and Grace would be liable for the tax.

- Assuming the bond is segmented
- They can assign segments to the children as required
- Not a chargeable event so no tax on parents
- Being offshore and children have no other income, they could surrender this and could use PA, 0% starting rate and PSA. Therefore they have no additional tax liability.
- Gifts would be exempt under IHT as they are for education/maintenance

If the IB is to be used and run down over the next 5 years they should consider switching funds into lower risk funds,

To review their protection needs

Current position very poor. Worth noting that Grace's DIS would be lost if she were to leave her job.

Additional information questions

- What income would Simon need if Grace were to die.
- What income would Grace need if Simon were to die.
- Has Grace nominated Simon for her DIS?
- Does Grace intend to stay with her current job?
- How long could the business function if Simon were to die or be unable to work?
- What are the profits of the business?
- What is the business currently worth?
- What sick pay does Grace get from her employer?
- Is retirement date of 60 a firm commitment?
- What income are you getting on your ISA's
- Would you be prepared to sell assets to cover any shortfall in income
- Do they want to pay the mortgage at the time of retirement/earlier
- Affordability both individually and for the business?

No life protection on mortgage

Problem is that this extends 9 years past preferred retirement age
They should address this but in the meantime we can only work on current position

Our solution would be:

- Mortgage protection policy (DTA) joint life first death SA £275,000, term 25 years plus CI + WOP
- To ensure mortgage is repaid on either death
- WOP to ensure premiums can be met if either unable to work.

To cover income/outgoings

- FIB on both (two separate policies but life of another to ensure speedy payment and outside the deceased's estate.
- To age 60 planned retirement
- With indexation to maintain its real value
- WOP to ensure premiums paid if unable to work
- Benefit £3,500 a month for Simon and £2,000 for Grace to maintain their standard of living

Possible question: use of Relevant Life Policy

- This taken out by his business
- Simon would be life assured
- Policy would be in trust with Grace and the children as potential beneficiaries
- Must be two trustees Grace obvious choice and Harry as he is over 18)
- Premiums paid by the business
- Can be a business expense
- Not a BIK on Simon
- No NI on either employer or employee
- If Simon dies
- Trustees would claim the proceeds
- And could pay to any potential beneficiaries in the trust
- Maximum is set as a multiple of salary
- No impact on Lifetime Allowance
- No impact on Annual Allowance

Business assets on death

Simon appears to be the sole shareholder and director

Possible question. "What would happen to the business if Simon were to die?

- As there are no other shareholders, directors or company secretary
- On Simon's death the company could still trade
- But its bank accounts would be frozen and couldn't pay its bills
- His administrators may be able to appoint further directors if the articles of association allow this

Follow this link to get more info on this.

https://www.roythorne.co.uk/site/blog/corporate-and-commercial-blog/the-risks-of-being-a-sole-shareholder-director

Action needed

- Appoint Grace as a director/company secretary
- Or change the articles of association to allow his administrators to appoint a director.
- Even if that problem is overcome his shares will be inherited by Grace
- Needs to give some thought as to how she can realise the value of the shares/business.

Further benefits of the business appointing Grace as a director

- She could be the life assured in another RLP
- She could have her pension funded by the business
- Could equalise salaries/dividends to become more tax efficient
- Makes it easier for business to continue if Simon dies

Specific issue in FF on ASU policy

- It doesn't cover his income/outgoings
- Only 2 years left although could be renewed
- No details of payment period but likely to be 12/24 months
- Difficult to get an unemployment claim paid because he is the owner
- No cover for his wife
- Renewable annually so cover could be withdrawn if his health were to change.

Clearly this is inadequate and there are two possible options:

- Individual IP policies taken out by Simon and Grace
- Executive IP

Individual policies (Recommend and Justify)

- Recommend an IP policy
- On Simon's life
- Benefit £3,000 a month
- To ensure standard of living is maintained
- 26 weeks deferred. (as they have adequate savings)
- Indexation to maintain living standard
- Own job
- To give widest claims
- To age 60 to match retirement needs

- Repeat for Grace
- Monthly benefit £1,500 pm
- Deferred period to match her sick pay period at work.

Executive IP

- Taken out by the company
- Premiums are an allowable business expense
- Simon would be taxed under PAYE if acclaim was made
- So it is not a P11D benefit
- Can normally cover a higher proportion of earnings than an individual policy
- Can include dividends and employer's NI and employer pension
- Premiums can be guaranteed or reviewable

To ensure their mortgage is paid off by retirement/at 60

Basically three options

- Start making overpayments
- Do a full or partial capital repayment now
- Carry on, some overpayments but plan to pay off remaining debt at retirement
- Complete remortgage

<u>Overpayments</u>

- Simplest way
- But may not be allowed as on fixed rate (need to wait until this expires)
- Reduce interest over time
- No investment risk
- Modest increases in payment could have significant reduction in time
- No need to cash investments

Full or partial payment now

- Debt cleared
- Peace of mind
- Reduces amount of life cover needed
- More monthly income
- Investments seem to be in profit
- Clearing debt would mean the risk of the business failing and therefore losing the property is eliminated

- Swapping liquid assets for an illiquid one/loss of capital
- ISA allowances would be lost
- OEIC sale would incur CGT
- Loss of potential growth
- Difficult to build up future investment savings.
- May be redemption penalties/not allowed by lender

Plan to pay off at end

- Debt will be lower
- Assets may be higher so less cost than full payment now
- Could use pension PCLS
- They would debt free on retirement.

- Incurring interest until then
- Assets could have fallen in the meantime/bad market conditions particularly at time of payment (60)
- Could incur tax charges

Complete remortgage term 15 years

- Might be a better interest rate package
- Certainty of being mortgage free at 60
- Risk free/no investment risk

- Could be redemption penalties
- Higher monthly payment/reduced income
- May have to remortgage at higher interest rates/may not meet lender's criteria
- Remortgaging will incur costs

To ensure they have sufficient income in retirement

Current situation poor. Limited pension savings and only 15 years to retirement

Additional Information Question

- What income/capital would you need in retirement?
- Inflation (expected)
- Past contribution record/ability to use carry forward
- Performance of funds/projections
- Can Grace increase her contributions into her employer's scheme
- What other funds does Grace's scheme offer
- Wil any increase be matched by her employer
- Willingness to use capital/savings to fund pension
- State Pension forecast
- Cost/charges of current arrangements
- ATR in relation to pension savings
- Affordability
- Ability of company to fund higher contributions
- Value of business

My business is my pension

There isn't much detail about Simon's business but it's reasonable to assume:

- No full time employees so it seems reasonable to assume that it is probably low skilled work, possibly packing and distribution
- Probably no significant physical assets
- Main assets are probably going to be the publishing rights the company owns
- And possibly the contacts Simon has with different authors.
- This makes it difficult to put a value on the business both now and at retirement

In terms of any fact finding we should also find out:

- What are the profits of the business?
- What is the equity and debt in the business
- How long could the business function if Simon were unable to work or he died

Problems with relying on business to fund retirement

- Business may not exist at time or retirement/gone bust
- Economy in recession, bad time to sell
- Ability to find a buyer
- Currently would qualify for ER but may be different when he gets to 60
- No specific death benefits
- May be forced to retire due to ill health
- Difficult to predict valuation.
- If business is sold then he has to make further decisions as to what to do with the money
- His children may wish to take the business over
- If the firm fails assets could be taken by creditors, they cannot take pension assets
- The risk has been concentrated in that if the business fails he loses his pension and his livelihood.

But

- "master of his own fate"
- No restrictions on when he takes the benefits

His existing PP

Possible question on whether future contributions should be made by him or company

- Simon's own contributions would get 40% relief, employer 19% (Corp tax)
- His own contributions reduce his ANI, employer contributions won't.
- Simon could use salary sacrifice.
- Employer saves NI (13.8%) on their own contributions
- Employer contribution not a P11D benefit
- Employer contributions not limited to Simon's NRE which means Simon could take more in Dividends and reduce his salary
- Also make a contribution using carry forward greater than his NRE
- Employer contributions. Tax free extraction of profit from company
- In trust so protected against bankruptcy

Benefits of increasing pension contributions

Classic example of stating the blindingly obvious!

- Increased income and or capital in retirement
- Individual contributions save tax
- Tax efficient growth whilst invested
- Benefits can be accessed flexibly
- Tax efficient death benefits
- Survivor benefits tax free if member dies under 75
- Pension fund out of the estate

Combining his pensions

- Letter of authority to be able to contact the providers
- Once got establish
- Funds invested in (Full details)
- Charges
- Past performance
- Reputation of provider
- Range of funds available
- Does any fund have a GAR?
- Do they have any transfer charges?
- Death benefits (do they allow all options)

Benefits of transferring old pensions

- Fund would be greater may have lower charges
- Easier to administrate/control
- Have a consistent investment strategy
- Could offer more flexible death benefits (if old policies under old rules)

Grace's pension

- Commercial property fund
- Within her ATR
- No diversification/all UK based
- More focussed on income rather than growth
- Potential liquidity problems

Explain what is a Targeted Absolute Return Fund

- It is a fund that aims to get positive returns under all circumstances
- But is not guaranteed
- It will make more use of derivates
- Also "short selling"
- And assets not correlated to the equity market
- Manager decides asset allocation

Reasons why it may not be suitable

- She has a medium ATR and the use of derivatives and short selling is likely to make this inappropriate
- As manager has total discretion, she may end up investing in assets that are too a higher risk for her.
- Won't match her ethical stance
- They tend to operate on a short term time horizon which may not be appropriate for a 15 years term
- Charges/performance fees could be higher thereby reducing growth
- Difficult to evaluate performance against a benchmark
- Possible lack of diversification if only one fund
- Could underperform in a rising market
- Could outperform in turbulent times.
- She is investing for medium term so issue of short term fluctuations becomes less significant
- Past performance of these funds has been mixed.

Good principles to follow

- Fund or funds should cover all three main asset classes
- Charges should be low
- Benchmarks should be set
- Mixture of active & passive
- Regular reviews with rebalancing

Final Review Question

Standard template

- Fund performance
- Change in personal circumstances
- Rebalancing
- Change in tax or legislation
- Change in economic
- Top up ISA/Pensions