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Case study 1

Overview

John and Emily are 63 and unmarried. They are coming up to a key life stage in that they will be both be retired in two years time. Emily has a dependant's FAD from her late husband. The value is £600,000 and she has been withdrawing £1,000 a month.

John is still working and has a pension fund with his current employer of £320,000. He also has a PP with a very attractive Guaranteed Annuity Rate.

John is cautious and Emily is a medium risk investor

We have no further details of their income from investments.

Stated Objectives

- Generate an adequate income in retirement
- Ensure their current investment holdings are suitable and tax efficient
- Ensure that John's estate can be passed on tax efficiently as possible to his children

Generate an adequate income in retirement

Questions could cover:

- How john could increase his pension fund in his last years of working
- How Emily can get a sustainable income from her FAD
- How John should take income from his pension fund

State the additional information you would need to advise them on ensuring they have an adequate income in retirement.

Breaking these down into groups:

General questions

- What income will they need in retirement?
- Survivor's retirement income need
- Planned capital spending
- Pattern of income/spending
- What is their income from current investments

- Willingness to use other assets
- His willingness to additional charges and Admin if he goes for FAD
- State of health/family longevity
- Attitude to risk in drawing pension
- Capacity for loss of income in retirement
- Do either of you have any preserved benefits or other pensions?
- Any expected inheritances

John's pension arrangements

- Willingness of John to contribute more to his pension
- Would this be matched by employer?
- Will John's scheme allow benefits to be taken flexibly
- Contribution history/amount of unused relief
- Any other funds available in the scheme?
- Is there a scheme specific lump sum protection
- Who is the nominated person(s) of John's pension scheme
- Will John's PP with the Guaranteed Annuity Rate accept further contributions or transfers
- What is the current bonus rate and is an MVR reduction being applied
- Is it a level pension and does it include any inflation linking

Emily's pension arrangements

- What funds is the FAD invested in/asset allocation
- Who is the nominated person(s) under FAD
- What is being charged?
- What is their mandate
- How was the £1,000 withdrawal established?
- What was fund performance
- Has Emily inherited part of her late husband's SERPS?
- Does she intend to work again/Is retirement age the same as John's, i.e in two years time

How to take the benefits

- The importance of PCLS?/How much cash sum would they need
- Need for flexible income in retirement./Importance of flexibity v guarantees
- Importance of transferring pension to future generations
- Importance of death benefits

This is an extensive list so you should make sure you read the question carefully and establish exactly what you are being asked to do.

What factors would you take into account in advising on their retirement income needs?

- No mortgage/no other debts
- Emily has a dependent's FAD fund of £600,000
- This will tax free for all of her life as her husband died before 75
- She can nominate a successor to take the fund when she dies
- If she nominates John and she dies first, she can't guarantee that daughter will be nominated successor
- She is only withdrawing 2% of the FAD fund so is likely to be sustainable.
- Emily's pension provision is larger than John's
- There could be scope for additional input into John's fund
- He has a very attractive annuity rate from his PP but this would not give a spouse's pension
- Both get a full state pension but John will only get his state pension a year after retiring
- John is a higher rate tax payer, Emily is a non tax payer
- Both want their own children to benefit on their death

State the benefits and drawbacks of Emily using a Discretionary Fund Manager

<u>Benefits</u>

- Professional management/wider investment options
- Potentially higher returns
- Bespoke service
- No requirement for ongoing involvement

<u>Drawbacks</u>

- Higher charges
- No guarantee of better performance
- May breach mandate
- May not provide regular reviews

How would their state pensions be calculated?

- Their pension would be calculated as at 6/4/16
- The greater of their current pension including any SERPs/S2p
- And the pension if it had been calculated under the new rules

- If the pension was more than £155pw the excess is called your protected benefits and increased in line with CPI until state pension age

If Emily were to die, explain in detail the options regarding her FAD fund

- Administrator would check if she had made any nominations
- These are not legally binding
- The nominated persons could either:
- Take a cash fund
- Buy a nominee's annuity
- Designate it as a successor's FAD
- All benefit tax free if Emily dies under 75 and designated within two years of death
- If she dies over 75 or not designated within two years of death taxed as income on recipient's
- If no nomination had been made the administrator could decide and as she has no dependants all three options would be available.

There is a potential issue because this is a relationship where both have children from previous marriages.

If Emily nominates John and she dies first, he can nominate his children as his successor which means her daughter would lose out. She could have course nominate her daughter but this could mean John has insufficient income. This is why it's important that John's income requirement if Emily dies first is important.

An alternative would be to nominate both her daughter and John with say 75% going to her daughter and 25% to John.

A further alternative would be to nominate an IPDI trust (which she would set up in her will) to receive any remaining FAD fund. This would nominate John as Life tenant and her daughter as remainderman. This takes the assets out of the pension regime. It would also be taxed at 45% if she died after 75 or it was not designated within two years of death

How can John increase his pension provision?

With two years left to work John has a final opportunity to increase his pension fund.
His current input is £15,000 a year and his contribution is £7,500

This means he could contribute an additional £25,000 which would be tax relievable as his NRE is £75,000.

This could be funded from his deposit account (£100,000)

A key issue is whether the PP with GAR will accept any further contributions. If they do any further contributions should be made into this rather than the occupational scheme

The benefits of further pension contributions are.

- Immediate contribution would be £20,000 (20% at source)
- Total relief of 40%
- Increases his pension fund
- No tax within the fund
- Increases potential PCLS
- Having contributed 100% in current year, could use carry forward to mop up unused input for the last three tax years only limited by his NRE £75,000)
- Next year he could top up to £40,000 and should have about £420,000 in his fund
- The money will be outside his estate

Note on carry forward

Personal input into a pension is restricted to 100% of NRE. In the current year he has already contributed £7,500 but he can make a further contribution of £25,000. This uses up his £40,000 AA and his own input is £32,500

On the assumption he has unused allowances from previous years he can carry these forward but his limit will be £42,500 as this plus £32,500 totals his NRE of £75,000

Is his fund appropriate?

- All in Fixed Interest fund
- No diversification
- Matches his ATR
- If interest rates rise, price will tend to fall.
- Would be suitable if he plans to buy an annuity. Less volatile plus if gilt yields fall this will lower annuity rates but gilt prices (and therefore the fund value) will rise meaning that he would have more money to purchase the annuity.
- Not suitable if he wants to take benefits flexibly

How should he take his pension? (possible factors question)

- Can't give a definitive answer without knowing how much income they will require
- But Emily has a tax free income from her dependant's FAD therefore their CFL is increased.
- Annuity matches his ATR
- PP with GAR would give an income of c £7,300
- State pension of about £8,500 to £9,000 at 66

- Annuity would not be suitable to give money to dependants on death. Only option would be nominee's pension with poor rates as children young
- Possibly use PP with GAR, State pension plus Lifetime annuity to make up sufficient secure income to cover essential outgoings and balance into FAD.
- Could also use PCLS to fund any shortfall between retirement and state pension

Ensure that Investments are suitable and tax efficient

<u>Immediate position</u>

- John has a large amount of cash on deposit
- Above FCSCS limit
- Interest rates likely to be poor
- May have used up his PSA
- Lack of diversification
- CB funds don't match Emily's ATR
- Emily has a large amount on deposit
- Emily's APS fund is being held in cash and should be invested in a wider range of funds as soon as possible
- As Emily's income is mainly tax free (FAD) she will probably be a non tax payer
- Any taxable income investments that John has should be transferred to her but may conflict with their wish to keep investments separate This would enable her to use her PSA and 0% starting rate.

Questions on her APS

The case study is a little ambiguous. The implication is that the executors have passed her the underlying assets and these are currently held totally in cash. If this is right then she has used her APS and it is being held in cash

- She can choose a different manager to her husband but cannot split the APS between different managers
- She can select whatever funds she wishes

John's estate

This is more complicated than might appear at first glance. Whilst the stated objective is to ensure that John's estate is passed as tax efficiently as possible to his children, there are problems created by the joint ownership of the house.

The case study states that “John and Emily have agreed that he will leave his entire estate except their jointly owned home to his children on his death.” This implies that her daughter should inherit the property under all circumstances.

As things stand:

- If John dies first, Emily becomes sole owner and she can pass it on to her child through her will. His share of the property (£200K) would be included in his estate.
- But if Emily dies first, John inherits and is free to pass house to his children through his will which seems to be not Emily’s wish.

In addition in the second scenario even if John wills the house to Emily’s daughter his estate will include the house with a value of £400,000 at today’s prices.

This might form part of a “comment on the existing arrangements to ensure Emily’s daughter receives the house”

It seems that we have to try and solve two problems:

- How to ensure that Emily’s daughter will get the house no matter who dies first.
- To try and mitigate John’s IHT liability so that his estate isn’t increased by the value of his share of the house.

The first step would be to change the ownership to Tenants in Common. This is normally on a 50/50 basis so each can leave their share of the property to whoever they choose.

In practice if John dies first his share goes to Emily who can then pass it on to her daughter and can use the RNRB.

If Emily dies first her share goes to John but she should write a **mutual will** which will result in the house passing to her daughter on John’s death. Crucially whilst the will can be changed whilst she is alive it cannot. This means that when she dies there is certainty that her daughter will inherit although she couldn’t use the RNRB as it would be passing from John and her daughter is not a direct descendent.

Whilst this would ensure that her daughter inherits the property John still has in the first scenario £200,000 added to his estate and £400,000 in the second.

In scenario 2 this creates an IHT liability of £150,000

House	£400,000
Joint Bank Account	10,000
Deposit account	£100,000
Stocks & share ISA	£190,000
Total	£700,000
Less NRB	£325,000
	£375,000
£375,000 @ 40%	£150,000

His children will only get a gross gift of £300,000 but having paid IHT will only get £150,000.

Rather than set up a mutual will Emily could pass the house into an IPDI trust on her death giving John the right to live there until he dies and then the house would pass to Emily's daughter. This would mean the tax is shared proportionately between the trustees and John's executors.

Trustees £150,000 x £400,000/£700,000 = £85,714
Executors £150,000 x £300,000/£700,000 = £64,285

Therefore John's children get more money.

It might appear that one solution could involve John transferring the whole ownership to Emily but HMRC would regard this as a Gift with Reservation as he is living there and his 50% share of the property would always be considered part of his estate.

Splitting the ownership on a 50/50 basis would not be an issue since HMRC would not consider his interest had changed but any other split, say 80/20 would be challenged.

However the case study states Emily sold the former marital home for £300,000. It therefore is probable that she contributed most of the money for their new house. Let's assume she did contribute £300,000 and John £100,000 HMRC might be persuaded to accept a 75%/25% split without causing any problems over Gifts with Reservation.

This makes it better for John if he dies first as th evalue of the house in his estate would be £100,000. However if Emily dies first he would still have £400,000 in his estate.

Notes on Wills

- John's will is still valid after his divorce. If it leaves his property to his children there should be no issues
- Emily's will is still valid but should be should be rewritten as it may not have made provision for her daughter

Case study 2

Overview

Rafa and Lara are 60 and 53. They plan to retire in three years time. Lara is selling her business and expects around £1.5m. They have £205,000 in investments but no information about any income.

Rafa is likely to have lost part of his PA once rental profits from the Welsh cottage is taken into account

They have a holiday home in Wales which is let on an FHL basis. They are considering whether they should sell their current home and move there or sell the Welsh cottage.

They consider themselves adventurous investors

Stated objectives

- Ensure their mortgages are repaid before retirement
- Put in place a suitable investment strategy to fund their retirement
- Ensure their investments are held as tax efficiently as possible

Repaying mortgages before they retire in 3 years time

Note mortgages is in the plural so we must deal with both mortgage on their main house and the cottage

Fact Find question

Based on main property

- What is the remaining term
- Interest rates on (both properties)?
- Fixed or variable
- early repayment charges
- Current cost/what are they paying per month
- Ability to increase payments
- Does the bank limit overpayments?
- Willingness to repay using capital

Holiday cottage

If they decide to sell then they have a lot of equity therefore they can pay off the mortgage then
If they decided to move there, the sale of the current home can be used to pay off the mortgage on the cottage.
If they decide to retain the cottage as a source of income then there is no need to repay as long as the rental income is more than the interest charged.

Options

- Increase payments
- Pay off from existing capital

Increase monthly payments to repay in three years time

Advantages

- Keeps capital intact
- Reduces interest payment/pay less overall
- Reduces debt
- Simple to organise
- No investment risk
- Peace of mind

Disadvantages

- Reduces disposable income
- Lender may not agree/impose a limit on overpayments
- For holiday cottage, reducing interest may not be efficient since income is an allowable expense (not restricted to 25%)

Using their available capital

Advantages

- Debt cleared straight away
- Higher disposable income

Disadvantages

- Early repayment penalties
- House is an illiquid asset, whereas transferred funds are liquid

- Lose potential growth on the encashed asset
- Possible loss of ISA benefits
- Paying off debt increases the estate

Pro's and cons of selling main residence or Welsh cottage.

They decide to sell Welsh cottage

- It has never been their PPR
- But whole gain is taxable at 10% using entrepreneur relief provided it had been owned for two years prior to sale
- Loss of rental income

Sell the house, move to Wales

- No CGT on sale of main home as it is their PPR
- When house disposed of, PPR period on Welsh property will start once they move in.
- Pre moving in then no PPR but they could used Entrepreneur's relief IF the cottage was sold within THREE years of it ceasing to be a FHL. Otherwise charged at normal property rates 18%/28%
- Produces more money than selling the main house

What are the benefits of retaining the cottage as a FHL?

Benefits for FHL

- It gives them extra income
- Classed as trading business
- Can use capital allowances
- Classed as Net Relevant Earnings for pension
- Can offset 100% of mortgage interest
- CGT gets entrepreneur's relief
- Losses can be offset against any income
- It may qualify for Business Relief (IHT)
- Can use holdover relief for CGT
- Offers diversification to their assets

Conditions

- Must be available for 210 days in a year
- Must be let for 105 days
- Stays longer than 31 days won't count
- In EEA and furnished

Investment strategy to fund their retirement

As in the first case study the time to retirement is quite short so their strategy is likely to focus on:

- Building up funds before retirement
- Invest fund post retirement (if drawdown taken)

Fact find questions

Similar to case study 1 but we need some other points

- What us the GPP fund value
- Contribution history
- What is the value of the property in Lara's SIPP and what is the rental income?
- What is the profit from the FHL cottage
- With the S32, what is the level of GMP
- Date left the scheme/revaluation of GMP in deferment
- Value of fund not needed to fund GMP
- Bonus currently being paid
- Is there an MVR free period?
- Does it have a guaranteed or protected cash sum

Factors

- We know he's in a GPP
- He has a S32 policy with a value of £220,000
- Lara will receive a substantial amount from the sale of her business
- She has a SIPP that includes the business premises.
- They have potential to use carry forward and have cash available to do that.
- If they keep their current house would they want to keep the cottage and receive rental income?

S32 explainer

- This is an insurance policy that bought out the rights from his former DB pension
- With profits fund
- It is a money purchase arrangement but there are specific guarantees about any Guaranteed Minimum Pension (GMP)
- The insurance company guarantees that it will pay the revalued GMP at 65 (even if state pension age is higher) so he can be no worse off than if he had remained in the scheme, at least as far as the GMP is concerned.

- If there is money left after funding the GMP this can be treated as a normal MP fund and 25% PCLS can be taken.
- If Rafa dies before SPA the fund can be paid to Lara (depending on scheme rules)
- On death after taking benefits Lara would get 50% of the revalued GMP

Carry forward

- Both are members of a registered pension scheme
- Both must use up current AA (Lara would have to use a company contribution)
- Go back three tax years
- Start with earliest year first
- Carry forward unused relief to current year
- Rafa's employer would probably not be prepared to make further contributions so the maximum he could contribute would be limited to NRE of £98,000 but could also include 50% share of holiday cottage profits as these are NRE
- Lara could use the business to fund her contributions and not be limited by her NRE

Benefits

- It increases their potential pension
- It increases their potential PCLS
- Rafa would probably get is income tax PA back plus relief of 40%
- Lara's contributions would come from the business so extract profits into a tax free environment.
- It offers tax efficient death benefits/fund is exempt from IHT

Lara's business property in her SIPP

It's not clear that whether the new owner is buying the property or will rent it from the SIPP

- If it is sold to the new owner it will not be pension input
- The value of the SIPP will remain the same
- But an illiquid asset will have been "swapped" for liquid cash which can be invested into other assets.
- No CGT on the sale of the property
- But future rental income & growth will be lost
- Which may be higher than the income obtained from reinvesting

- If it is not sold
- Rental income will continue and this will not be classed as pension input
- It will not incur a tax liability
- But if new owner fails

- Then no rental income and may be difficult to sell and the purchase price may be lower than what could be obtained now.
- Keeping the property in the SIPP could also present problems if she wants to use drawdown.

Whilst it's a little in the future there could be questions as to whether they should use a Lifetime annuity or FAD to provide his post retirement income

Lifetime annuity

- Guarantees income for life
- Guaranteed payment period
- Benefit from mortality gain
- No admin, no advice costs when payments start
- Free to choose structure
- Dependent's pension tax free if member dies under 75

<u>Drawbacks</u>

- May not meet their ATR
- No flexibility/can't change once purchased
- Current rates are poor
- Survivor could only receive an income which they may not need
- No one else can benefit
- No possibility of passing capital on unless annuity lump sum protection chosen
- Current rates are very poor
- Original capital is lost

FAD

<u>Benefits</u>

- Take income flexibly
- Matches their ATR
- Capital can be passed on death
- They can have investment control/benefit from further tax free growth
- More flexible death benefits
- Keeps their options open, could always buy an annuity later

<u>Drawbacks</u>

- More admin/more costs
- Fund may be exhausted/income can run out/be reduced

- Investment risk
- Sequencing risk
- Once income is taken you are subject to the MPAA

Asset split of a drawdown

- Cash To pay first 12/24 months withdrawals & pay for charges
- Bonds To provide some growth but also hedges the annuity risk
- Equities & Property To provide growth

Possible question on stress tests if one or both go for drawdown:

- Market crash
- Inflation higher than expected
- Investment returns lower than expected
- Need for capital withdrawal
- Living longer than expected
- Need to take a higher income than anticipated

Tax efficiency

- Looks pretty good
- Mainly in ISA
- Multi Asset Funds (but would need to check asset split to assess if it matches their ATR)
- All in ISA except commercial property fund represents about 20% of assets in risk
- Main return is income
- Not tax efficient
- Income paid as non-savings income with 20% deducted at source.

Alternatives to this fund if they want property exposure

- Buy property company shares
- Invest in a REIT or PAIF
- REIT produces PID which comes from rental income of property held by the company
- The company does not pay tax on this rental income
- Paid to investor with 20% deducted but can be placed into an ISA

- EIS possible for Rafa as income tax liability greater than Lara's
- 30% relief but capped at Rafa's income tax liability

- Sale of her business would be subject to Entrepreneur's Relief so charged at 10%

Setting up a trust

Benefits and drawbacks of writing a trust rather than making absolute gifts to their children.

- It gives the parents control over the money whilst they are alive
- And can write a letter of intent to the trustees to carry on their wishes after death
- Straight gift, recipient can do with it what they like.
- Protects the money being squandered by the recipient
- Protects the trust against bankruptcy of the recipient
- Protects assets against divorce of the recipient
- Can benefit people not yet born e.g. grandchildren

- There is no immediate benefit in making gift into a trust
- It will be a CLT and provided it is below the NRB there is no immediate tax charge
- If they make a joint gift they can each use the NRB and will be deemed to have set up two trusts
- Both their NRB will be reduced by the amount of the gift for the next seven years
- However the gift is "frozen" at the time of the gift
- The property will not be considered to be in any beneficiaries' estate
- But it will be subject to periodic and exit charges
- A Discretionary Trust will probably the most appropriate
- Who do they want to benefit?
- They should be trustees but would need to appoint a least one other to continue after their death

Possible question: Explain why the trust should use an investment bond as its investment vehicle?

- An IB enables the trustees to invest in a wide range of funds thereby meeting their need to have diversification.
- Tax is only due when there is a chargeable event.
- Switching between funds is not a chargeable event.
- An income can be produced using 5% of the original investment
- By assigning segments to a beneficiary there is no tax due within the trust and liability will fall on the beneficiary
- At their own income tax rates
- And they can use top slicing.
- Thereby trustees will not have to complete any tax returns

State the factors you would take into account in advising them whether to retain the life and critical illness policy

- SA both life and CA
- Definitions of illnesses
- What they are paying for it
- Guaranteed or variable
- Can the SA/Is it fixed
- Can terms be altered?
- When is the next review?
- Does it have an expiry date
- Is it investment linked or pure insurance
- Does it have a surrender value?
- Original reason for taking it out
- Is it in a split trust

Factors to consider

- Their need for life protection is limited because of Rafa's DIS and significant assets
- If a claim occurred it could increase the estate of the survivor
- Surrendering it could be appropriate and more disposable income
- But it may be possible to change it to pay for any IHT liability
- Joint life second death, written in trust for beneficiaries

Should Rafa join the Group PMI

Questions

- Level of benefit
- Would Lara be included
- Any underwriting for him
- P11D benefit/potentially increasing ANI

Benefits

- Offers speedier health treatment
- More choice of surgeon/hospital
- Could include Lara
- May be possible to continue after retirement

Review Question

The basic template for this is

- Any change in personal circumstances
- Change in ATR/CFL
- Any change in taxation/legislation/economic conditions
- Current charges
- Review Investment performance
- Rebalance investments
- Use up any annual allowances (ISA pension)
- Any new products available

This is usually the last question on case study 2 but Emily's FAD fund in case study 1 lends itself to a review question.

- Fund performance
- Rebalancing fund
- Change in legislation
- Change in ATR/CFL
- Income required in next 12 months
- Any capital required in next 12 months
- Review nominations
- Review current annuity rates

Case study 1

Discuss key areas when she gets £1.5m

- Establish/confirm tax liability
- Immediate capital spending e.g world cruise
- Review ATR/CFL
- Review IHT liability as she will no longer benefit from Business Relief
- Agree amount paid into trust
- Joint or single
- Agree type of trust
- Decide who are to be the trustees and beneficiaries
- General purpose of the trust
- Top up all available allowances
- Decide on balance between pension and non-pension new investments
- Review wills & pension nominations
- Write new wills including charitable legacies to ensure 36% rate is available.
- Make lifetime charitable legacies