AF5 March 2021 Notes

Analysing an AF5 fact find is somewhat like a doctor examining a patient, identifying what the problems are and then identifying the best treatment. A first examination reveals some key points.

Harry and Pauline Williams, 74 & 73 respectively and have been retired for a number of years. Henry recently had a heart attack and this has caused him to reassess their finances.

They have the foundation of a joint guaranteed income of £43,680 through a mixture of private and state pensions. In terms of net income:

Harry	£27,080	£27,080
Less PA	£12,500	
	£14,580 @ 20%	£2,916
Net Pay		£24,164
Pauline	£16,600	£16,600
Less PA	£12,500	
	£4,100 @20%	£820
		£15,780
Total net income	£39.9944	

Their outgoings are shown as £46,930 so there is a shortfall of £6,886

They have available savings of £932,000 plus Harry has a Drawdown Fund of £630,000 so filling this gap should not be a problem.

The first issue is that the way this is currently being taken is not tax efficient.

Pension arrangements

There are some unknown facts that could form the basis of an “additional information” question.

- Recent state pension statement showing amount if additional state pension.
- What was his pre-commutation pension when he retired?
- Is there a cap on the RPI escalation?
- Will Pauline’s spouse’s be based on the pre commutation pension?
- Will spouse’s pension have the same escalation?
- Scheme funding details

- Amount of PCLS when SIPP was designated a FAD and amount placed into FAD?
- Amount of LTA used/remaining amount of LTA?/Transitional Protection.
- Why is he withdrawing £3,000 a month?/what is he doing with this money?
- Asset allocation of FAD.
- Fund performance
- Charges
- Any uncrystallised pension left?
- Which assets are being used to provide income?

Technical note. Why is it unlikely that there would be an LTA charge when Harry reaches 75 in October?

- A BCE check would have to be made on his 75th birthday
- No check on his DB pension
- The growth of his SIPP since it was crystallised as a FAD would be tested.
- This is the value on his 75th birthday less the amount designated as a FAD (excluding any PCLS)
- As he has been withdrawing £3,000 a month and we are told the performance has been disappointing the current value is less than the original so there can be no be no charge.
- There will be no BCE after his 75th birthday

Possible question on what pension would Pauline receive if Harry were to die

- Harry's Basic State Pension would cease
- But she would receive 50% of his SERPS/S2P benefits.
- Pauline would receive £10,250 from his DB pension (this could be higher as scheme pay 2/3rd of his pre commutation pension
- Harry's SIPP. Pauline would have the choice of Cash refund, Dependent's annuity and Dependant's drawdown (tax free if Henry dies under 75)

Technical details on SIPP choices

- Taking it as cash would take it out of the pension regime so it would lose its tax benefits and would be part of her estate. Harry is only eight months off 75 so taxation would be punitive if he died after that and she took it all as cash.
- Buying a lifetime annuity would mean the pension would cease on her death.
- Designating it a dependant's FAD would mean that she could withdraw whatever she likes and any funds remaining on her death could be passed on to the children as a successor FAD.
- None of these would be a BCE so no effect on her LTA

Current FAD policy

- Taking £36,000 a year is not advisable
- This income isn't needed/He has alternative sources of income.
- It takes it out of a tax free environment into one that is taxed
- The SIPP is exempt from IHT so making withdrawals that isn't spent increases the estate.
- He has £22,920 of the basic rate band left so therefore £13,080 is taxable at 40%.
- It also means that his PSA is reduced to £500
- He has £8,400 of non ISA dividend so £6,400 is taxed at 32.5% rather than 7.5%
- If he is a higher rate tax payer there would be a 20% rate for CGT compared to a 10% for a basic rate tax payer.
- Withdrawals are high but at his age there is a reasonable probability that the fund would not be exhausted.
- Withdrawals should cease to allow the fund time to recover.
- Charges may increase if fund value reduces.

Investments

This is a summary of their current investments

	Harry	Pauline	
Deposit account	16,000	16,000	
Cash ISA	95,000	40,000	
Premium Bonds	50,000	50,000	
Share Portfolio	240,000		
Investment Trust	120,000		
S/S ISA CB		£115,000	
S/S UK Global Tracker	£190,000		
Total	£711,000	£221,000	£932,000

In percentage terms

Cash	£267,000	28.65%
Bonds	£115,000	12.345
Equities	£550,000	59.01%

- Their investments are not held as tax efficiently as they could be and lack diversification.
- In a perfect world, all the investments would be in ISA wrappers. Harry's share portfolio and his Investment trust have no tax protection so dividend income will be taxed as divide and disposals will be subject to CGT.
- Whilst the share portfolio and the Investment Trust give diversification, they each have their ISAs in one single fund. This is not as diversified as it could be and means the holdings are above the FSCS limit if they are in one provider.
- An immediate solution would be to transfer their cash ISAs into equity ISAs to get greater diversification and consider switching some of their existing ISA into other funds.
- A longer term solution would be moving the IT and share portfolio into ISA wrappers but this is constrained by the £20,000 subscription limit. In addition selling existing assets would be a CGT disposal and therefore restricted to gains of the annual exemption each tax year.

Comment of their current tax situation

- He has £22,920 of the basic rate band left so therefore £13,080 is taxable at 40% if he keeps withdrawing current amount from his FAD.
- It also means that his PSA is reduced to £500
- He has £8,400 of non ISA dividend so £6,400 is taxed at 32.5% rather than 7.5%

- Pauline has £900 of the 0% starting rate band left plus £1,000 PSA so pays no tax on her savings income.
- She has no dividend income so is not making use of the £2,000 Dividend Allowance
- They have £8,300 of tax free ISA income
- They have used their ISA allowance for this year

How they could improve their tax position

- Harry could transfer up to half his individual share holding into Pauline's name giving her £3,000 of dividend income so she could make use of her £2,000 dividend allowance.
- They should make use of their ISA allowance each year.

Comment on the suitability of their current investments.

- Total amount in deposits (£167,000) is too high taking account of their ATR, level of secured income and that they have no current spending plans.
- They hold the maximum on Premium Bonds. These pay 1% into the prize fund and it is estimated they have a 98% probability of beating the best current savings rate.
- Harry's shareholdings may or may not be suitable depending on which companies the shares are in.
- They are all UK based.
- Harry's Investment Trust appears to have global exposure and will be actively managed.
- He has made a substantial gain.
- Yield is only 2%
- Pauline's ISA in in UK corporate Bonds so no exposure to Gilts or overseas bonds
- Yield is 3%
- Harry's ISA is in passive funds and has global exposure Yield is 2%
- There is therefore a mix of passive and active investment.
- The income of £17,020 is more than they need to meet the gap between their guaranteed income and expenditure.
- Investments appear to be higher than current FSCS limit

Question on what they should do could cover a wide range of issues.

Additional information to give advice on their investments.

- What emergency fund do they need?/planned spending after his recovery
- When does Pauline's fixed term ISA end?
- Why do they hold the amounts they have in a cash ISA?
- What prizes have they had from their premium bond holdings?

- Full details of Harry's shareholding (may be a separate question, see later)
- How are they funding their ISAs/source of investment?
- What holdings does the Investment Trust have?
- For both their ISAs, investment growth/original investment
- Where was 20/21 subscription invested./any withdrawals from their ISA in 20/21
- Which indices does the Global Tracker Funds follow.
- What involvement does Harry want in future?
- Are they looking for growth or income?
- Would they consider withdrawing capital rather than using the investment income to fund their income shortfall?
- Willingness to transfer asset between them.
- Providers' details to check if FSCS limits have been breached.
- Credit rating of bonds in her CB fund
- Gearing level in the Investment Trust
- Charges

Possible question on the disadvantages of their DIY approach

- Lack of any strategy.
- No investment objective
- No benchmark selected.
- No performance review.
- No rebalancing.
- May not be making full use of allowances and exemptions.
- Lack of research
- No FCA protection

Harry's share portfolio

- Harry has purchased the shares himself, presumably without advice, so he will have all the documentation, therefore no need to get a letter of authority.
- Establish if he had any strategy in buying these shares.
- An adviser would need to document all the individual holdings:
- Date when purchased.
- Acquisition price
- Current price
- Dividends being paid/yield.
- Any "shareholder perks"
- Does he have any shares that he wants to retain?
- Calculate gain over the last five years and compare with FTSE all share index
- Shares should be split into sectors to establish if investment is diversified.
- Consider selling poor performing shares to create a CGT loss

- Broking platform used.
- Any shares classed as AIM.

The fact find states Harry wants to manage his shareholding more efficiently

- Transfer the shareholdings and other investments on to an open architecture platform
- The transfer would be *in specie* so would not be a disposal for CGT
- The shares would be on a nominee basis so no need to retain certificates.
- Shares could be exchanged for collective investments although this would be a disposal for CGT so should keep within the £12,300 annual exemption..
- The platform would enable them to have access to their assets 24/7
- It would provide statements showing dividends making it easier to fill in tax returns.
- It would give him details of individual performance.
- It is simple.
- Could benefit from the platform's research.
- May lose voting rights.

- It will take a long time for the shares to be transferred into collectives or into an ISA.
- Is Harry content to adopt a "buy and hold" strategy for the shares held on the platform?
- Could consider a DFM service but are Harry and Pauline willing to pay for this?

Recommendations to amend the portfolio

Pauline should transfer her cash ISA into equity based ISA because

- She is holding too much cash.
- Equities match her attitude to risk/cash does not match her attitude to risk.
- Cash exposed to inflation risk.
- Interest rates currently low/interest rate risk.
- No growth potential on cash/potential for growth on equities.
- Transfer maintains ISA wrapper/transfer does not use current year ISA.
- Wide fund choice/hold on platform/active/passive.
- Suitable for long-term investment.
- Personal Savings Allowance covers interest on cash ISA/ISA wrapper is wasted on cash.
- Increase diversification.
- Equities generally outperform other assets.

They should both switch some of their current ISA holdings:

- Switching means the ISA status remains the same.
- Greater number of funds means they can achieve more diversification across geographical areas and sectors.
- Can bring the fund within the maximum FSCS.
- Wider fund choice
- Mixture of different investment styles.

One key decision in this Fact Find is how the additional income of just under £7,000 should be taken:

- The obvious method is to take the income from their ISAs as this is tax free.
- They have a number of other options.

- Take withdrawals of capital rather than income.
- Reduces the total estate
- "Income" is tax free
- Taking capital from Cash ISA is tax free but reduces the amount that can be transferred into a S/S ISA
- Income from cash is very low so better to use this as it enables income from equity and bind funds to be reinvested.
- Individual shareholdings could be encashed as long as this did not create a CGT liability.

- Could consider a "core and satellite" strategy.
- Core is Harry's tracker ISA offering a range of the main markets.
- Satellite would be his global equity fund and Pauline's Corporate Bond fund and Harry's individual share holdings.
- Consider switching shares into funds with limited income

Technical note Investment Trusts

- An investment trust is a PLC whose shares are listed on a stock exchange.
- The company invests in the shares of other companies.
- The trust's holdings should be checked to see whether it matches their ATR.
- The price is determined by supply and demand rather than the value of the underlying assets
- It can borrow to purchase new assets which magnifies any gain but also increase any loss
- The shares are trading at a premium so the share price is higher than the value of the assets behind each share.
- This may give Harry an opportunity to sell part of his holding.

Estate Planning Factors to consider

- They have a liability of £284,000 based on current values on second death.
- The WOL life policy would currently pay off the bulk of the IHR liability.
- Currently would have double NRB and RNRB (£1 million on second death)
- RNRB would only be available if house passed to children or grandchildren
- No tapering of RNRB but only £250,000 short of threshold.
- They have not made any previous gifts.
- Affordability of making gifts.
- Their willingness to make gifts.
- Their willingness to use trusts.
- As they are in their 70's the probability of surviving seven years to make a PET exempt is a consideration.
- This particularly applies to Henry so any PETS should be made by Pauline.
- They should make any gifts as soon as possible to start the seven year period.
- Emily is considering a divorce is significant as any gift could be part of and divorce settlement.
- Harry's drawdown fund is exempt from IHT.

Mitigating IHT

- Harry should stop making withdrawals from his SIPP
- They should both use their annual exemption (£6K each for this year)
- They could both consider using the small gifts exemption to give £250 to each grandchild every year.
- Grandchildren's ages aren't given but could be getting married in the nest five years so could use the marriage exemption of £2,500
- Pauline could consider making a significant PET to the children.
- The gift to Emily should be via a trust (IIP) so it would be outside the marital assets.
- Or simply wait until the divorce is complete before making a gift.
- Alternatively, a discretionary trust could have both children and grandchildren as potential beneficiaries.
- Take "income" by withdrawing capital to reduce the estate.
- Income from investments could be paid to children and be exempt as "gifts out of normal expenditure".

The whole of life policy

This would appear to be a unit linked policy that was set up on a maximum basis (as evidenced by the low surrender value) which was designed to pay off any IHT liability.

Technical note Universal Whole of Life Policies

- A policy is taken out with a guaranteed SA set normally for 10 years
- The premiums buy units in a fund(s) which are then cancelled to pay for the life cover for that month.
- The amount of the cover is the difference between the value of the fund and the guaranteed death benefit.
- The policy could be set up on a maximum or minimum life cover basis.
- If on a maximum basis it was unlikely that the fund would grow and therefore need to be reviewed at the 10th anniversary and then possibly annually.
- If on a minimum basis the same premium would buy a lower SA but would be guaranteed if the growth in the fund was 5%

Need to establish:

- Was it set up on a maximum cover basis?
- What funds is it invested in?
- What is the new premium from May?
- If it is renewed what will be the frequency of future reviews?
- How much can they afford to pay for this?
- Who are the trustees and beneficiaries?

Options

- If it is affordable there may be a case for keeping the policy particularly in view of Harry's health,
- However, the policy only pays out on second death so this may not be a significant issue.
- They could renew on the higher premiums but if this then rises on an annual basis it may become unaffordable.
- Amending the basis to minimum cover would mean an immediate hike in premiums but the cost of paying the life cover may be more sustainable.
- They could check what life cover could be purchased if the existing premium were maintained.
- They could surrender the policy.
- Pauline could take out a WOL policy in her name (written in trust) on a level premium basis.

A radical alternative would be for Pauline to set up an IIP trust and gift £200K. This could be used to purchase an Investment Bond,

- Pauline, Harry, and the children would be the trustees with the children as beneficiaries.
- This would prevent the children getting the money whilst one of the parents was alive.
- On second death the children could assign the bond to themselves and use the proceeds to pay off the IHT.
- This is not a CE so no charge on trustees.
- Andre and Emily would be taxed on their situation but could use top slicing.
- The gift would be outside Pauline's estate after 7 years.
- Growth would be outside the estate and would therefore give protection against a rise in the IHT liability.
- If Pauline died within seven years she would lose £200,000 of her NRB.
- This could be protected by taking out a 7 year level term policy on her life written in trust for the children. SA £80,000 (£200,000 @ 40%

This is not perfect as the beneficiaries would have to pay tax on the gain.

Lasting Power of Attorney

- Having an LTA is essential for most individuals especially for a couple in their 70's
- It could be particularly beneficial for Harry in case he loses mental capacity and could be for financial and/or welfare
- It has to be done on a prescribed form
- It must be signed dated and witnessed.
- It must be signed by an independent third party (the certificate provider)
- It comes into effect when it is registered with the Office of the Public Guardian

Left field questions

Bearing in mind Harry has been a DIY investor it's possible to envisage a question where he might be considering a high risk or "dubious" investments such as:

- Cryptocurrencies
- Mini Bonds

Both the above are too higher risk for them and are dubious in that cryptocurrencies are probably a bubble.

Mini Bonds are not tradable and investors could lose all their money.

Neither are they regulated by the FCA

- EIS/SEIS/VCT

Do not match the client's ATR

- Special Purpose Acquisition Company

A company set up with no stated objective that aims to find another company to buy.

Final Review Question

Standard template

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

Finally what might be the objectives given to you in the exam.

<u>Immediate</u>

- To establish a strategic and tax efficient income.
- To review the best use of Harry's SIPP
- To review the suitability and tax efficiency of their savings and investments.

<u>Long Term</u>

- To mitigate the IHT payable on second death
- To ensure income is maintained for the rest of their lives

DON'T WORRY OR PANIC IF THESE DON'T COME UP IN THESE EXACT WORDS. THE QUESTIONS WILL TELL YOU THAT, FOR EXAMPLE *"WHAT ADDITIONAL INFORMATION DO YOU NEED TO GIVE ADVICE ON THEIR OBJECTIVE TO……."*

HOPEFULLY, THIS GUIDE WILL HAVE PICKED UP ALL THE TOPICS THAT ARE LIKLEY TO COME UP.

GOOD LUCK!