R06 April 2021 Version 2

These notes aim to cover all the key points arising from the April case studies. I have aimed to be as accurate as possible but the odd error may have crept through. So please don't rely on this as your only guide, read other sources and carry out your own research.

Good luck

Case study 1 Jim and Helen

The first issue to consider in this case study is the complex family relationship.

- Jim is a widower who now lives with Helen who is in the process of divorcing Bob.
- They have both made wills but as these are 10 years old they are unlikely to reflect their current situation.
- Jim's and his late wife's home was on a tenants in common basis.
- Following his wife's death he still owns 50% (£400,000) with the other 50% being placed into an IPDI trust. He has the right to live there for the rest of his life. On his death the trust property will revert to the children as the remaindermen.

Explain how Jim's estate would be distributed if he were to die today.

- His 50% of the house would go to his children either because his will provided for his death after his wife died or if no provision was made, they would inherit as his direct descendants.
- The children would automatically become owners of the trust property therefore own the property 100%
- The children would get all his other assets
- Helen would only receive their current account.
- She would lose her right to live in the property.

Explain how Helen's estate would be distributed both pre and post divorce (assume it passed all her assets to Bob)

- Pre divorce all her assets pass to Bob
- Post divorce Bob can't inherit (or be an executor) and she would effectively die intestate.
- Intestacy rules would mean that first in line would be her parents (if alive) then any siblings.

Identify the factors relating to Jim and Helen's current circumstances that should be taken into account by a financial adviser before advising them on the distribution of their estates and the need to mitigate Jim's IHT liability

- Jim and Helen are unmarried.
- They do not plan to marry for some years.
- Both have made wills but these are unlikely to reflect their current situations.
- Helen cannot inherit as things stand.
- Jim will want Helen to have security if he dies before her
- She will lose her right to live in the property
- If a new will is made it will be invalidated on marriage
- Once Helen's divorce is complete, Bob cannot inherit and her estate will be distributed under intestacy rules
- Jim's estate can use 100% of his wife's NRB and 100% of her RNRB as he is the life tenant of the IPDI trust.
- If Jim passes his share of the house to his children his executors could use 100% of his RNRB.
- Therefore his total available NRB is £1,000,000.
- Currently there would be no NRB on his estate and no IHT liability
- The AIM shares may qualify for Business Relief if held for two years.
- His SSAS would be outside his estate.
- Their businesses could benefit from Business Relief.
- They are both in good health.

What additional information that should be taken into account by a financial adviser before advising them on the distribution of their estates and the need to mitigate Jim's IHT liability and ensure Helen's financial security

- When do they plan to marry?
- When is Helen's divorce likely to be complete?
- Details of their current wills
- To whom does Helen wish to leave all her assets to Jim?
- When did Jim's wife die?
- Who are the trustees of the IPDI trust?
- Details of the trust
- Relationship between Helen and Rob's children
- How long have the AIM shares been held?
- Did Jim's late wife make any lifetime gifts?
- Has Jim made any gifts in the last seven years
- Willingness to make gifts
- Death benefits and Nominations of Jim's SSAS
- Value of their businesses

So what can be done?

- They should both write a new wills
- He could leave his share of the house to Helen absolutely.
- But this would mean that Helen would own the property jointly with Jim's children
- And she could leave the her share of the property to someone else on her death
- His will could set up a new IPDI trust giving her the right to live in the property but Jim's share would pass to his children on her death.
- But the house would be jointly owned by Jim's children and the trustees of the second IPDI trust.
- If Jim's wife died less than two years ago he could ask his children to consider executing a Deed of Variation to pass the house 100% to him
- He could then write a new will setting up an IPDI trust with Helen as life tenant and his children as remaindermen.
- If His wife died more than two years ago he could ask his children to end the trust using Saunders v Vautier rule and then writing a new will as stated above.
- There may be legal costs in cancelling the trust.
- The new IPDI trust could contain a clause stating that Helen loses her rights if she were to remarry or separate from Jim.

Technical notes

<u>Jim's will</u>

- If his will leaves everything to his late wife then clearly she cannot benefit.
- The benefit lapses so the rules of intestacy would apply.
- Therefore Jim' children would benefit assuming they were alive when Jim died.
- If this happened and they had no children, the surviving child would get everything.
- If a child had predeceased Jim but had children of their own, they (Jim's grandchildren) would benefit.

<u>Deed of Variation</u>

- This could be done if Jim's wife had died within the last two years.
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- If longer it cannot be done.
- Jim and his children would all have to agree to this.

<u>Saunders v Vautier</u>

- This is another method of winding up the IPDI trust.
- Again Jim and his children would all have to agree.
- There would be some costs as it would probably involve a solicitor.

IPDI Trust

- This is a trust that is set up in a will and comes into effect on the death of the testator.
- It gives a named person, the Life Tenant (in this case Jim) the right to live in the property and/or the right to income from capital.
- On the death of the Life Tenant the property/capital reverts to the remaindermen, in this case Jim's children.

Mitigating IHT

If we assume that Jim were to die tomorrow.

His "free" estate would be

House	£400,000	
Current account	£4,000	
AIM ISA	£50,000	
S/S ISA	£180,000	
Total	£634,000	
Less BR	£50,000	(AIM ISA if held for more than two years)
	£584,000	
Plus		
Trust Property	£400,000	
Total	£984,000	

The total NRB would be £1m so no IHT would be payable.

Technical Note Calculation of an estate when the life tenant of the IPDI trust dies

- This requires us to split the liability between the executors and the trustees
- In working out the estate we include the "free estate" that is what belongs to the deceased and the trust property.
- As things stand there is no IHT liability but let's assume that the property was worth £1m
- The total estate would be £1,184,000.
- The IHT liability would be £184,000 @ 40% = £73,600
- This would be split proportionately.
- Executors would pay £684,000/£1,184,000 x £73,600 = £42,519
- Trustees would pay £500,000/£1,184,000 x £73,600 = £31,081

Technical note Transferable NRB and RNRB

If Jim does not amend his will and assuming his late wife had not made any previous gifts Jim's estate could inherit her NRB and RNRB so currently there would be £1m available

If he writes a new will the situation would depend on whether Jim marries Helen and whether he passes a direct gift or into an IPDI trust

- If on death Jim is married and leaves everything to Helen it would be exempt transfer.
- If Helen leaves the house to Jim's children she could use Jim's RNRB as they are her step children.
- The situation would be the same if Jim sets up an IPDI trust.

- If Jim dies unmarried and leaves all assets to Helen that would be a chargeable transfer.
- His estate could use his and his late wife's NRB but no RNRB as Helen is not a lineal descendant.

- If he is unmarried and sets up an IPDI trust with Helen as the life tenant to receive all his assets that would be a chargeable transfer. His estate could still use his and his late wife's NRB but no RNRB would be available.
- On her death she would have one NRB and no RNRB.

Technical note Wills and Marriage

A will is revoked on marriage.
A will can be written, "in contemplation of marriage" which will remain valid after marriage.
Jim would have to state that he intends to marry Helen and vice versa
To be valid the marriage must be imminent.
This is not defined in the Act but the case study states they intend to marry in the next few years.
They could either bring the date forward (obviously after divorce)
Or write wills now and a new one once the marriage date is known

Explain how setting up an IPDI trust in Jim's new will could ensure that Helen is financially secure in the event of Jim's death and also ensure Jim's children would be protected.

- On Jim's death all the designated property would pass into the trust.
- Helen would be the Life Tenant and Jim's children would be the remaindermen.
- This would give her the right to live in the property for the rest of her life
- On her death the property would revert to Jim's children
- Jim's other assets can also be placed in the trust

- Helen will have a right to income
- But the capital will revert to the remaindermen on her death
- The trustees must balance the income needs of Helen and the capital needs of the remaindermen.
- This will mean the current assets must be rebalanced
- The trustees could advance capital to Helen.
- His children could instruct the trustees to switch the investments to income producing ones.
- The trust wording can include a clause that it is wound up if Helen remarries or she has to go into a care home.
- The trust property would not be counted as part of her assets in assessing financial support for LTC

Technical note taxation of IPDI Trust.

The trustees are liable for income tax on the trust's investments.
They have no PA, PSA or Dividend Allowance
Tax is payable at basic rate on all income.
Income will be paid to Helen with a 20% or 7.5% tax credit.
Helen will pay tax at her own rates but can offset the tax credit.
CGT is payable at 20% on disposals within the trust,
The trust has only half the annual exemption.

It may be more appropriate to invest the assets into an Investment Bond
It can give a diversification of assets to balance income and capital needs.
No tax is payable by the trustees until there is a chargeable event.
Helen can receive an income using the 5% withdrawal facility with no tax liability
On her death the trustees could assign the bond to Jim's children
This is not a chargeable event so no tax would be payable

Apart from the usual IHT mitigation such as using the annual exemption or making PETS there is another method

Explain why Helen should consider setting up a NRB Discretionary trust in her will rather than making an outright legacy to Jim (assume they are married)

- Currently Jim's estate could use both his and his late wife's NRB.
- If she passes her estate to Jim it would be an exempt transfer
- Her NRB has been wasted because Jim cannot inherit more than 100% NRB
- A legacy to Jim would increase his estate
- If she passes assets to the value of the NRB to a DT it would use up her NRB
- Jim and his children could be the beneficiaries
- She could write a letter of intentt as to how the trustees could benefit from the trust

- No one owns the trust property for IHT purposes
- There could be periodic and exit charges

Identify the factors that should be considered in giving advice on how to generate an adequate income in retirement

- They plan to retire at 65
- They will get state pensions in about 4 years time when they are 66
- They want to maintain their standard of living in retirement.
- Helen cannot benefit from Jim's late wife's pension
- Jim has a SSAS with a current value of £650,000.
- Helen has a PP with a guaranteed annuity rate of 8.6%
- She may have to give part of this up as part of her divorce settlement.
- Helen has substantial assets of £470,000.
- They have no debts.
- They are both in good health
- Where their businesses fit into their plans./value of their businesses.

<u>Additional information</u>

- Income needed in retirement.
- Have they got a State Pension forecast
- How much is his late wife's pension?
- Will this stop on his marriage?
- How is this increased each year?
- Income from current investments.
- Investment performance of his SSAS
- Details of its investments
- Charges
- Can Helen become a member of the SSAS?
- Ability to use carry forward?
- Affordability
- Any scheme specific PCLS?
- Trustee/administrator
- Any other members?
- What are the death benefits/nominations
- Importance of passing on capital on death.
- Time window in Helen exercising the GAR
- Could Jim become the second life on Helen's PP without losing the GAR
- What effect would pension sharing/earmarking have on the GAR
- Any inheritances to come?

- Value of both their businesses
- Will these be sold on retirement?

Technical notes SSAS

- A Money purchase occupational scheme
- Usually designed for directors who own the business
- Can allow the SIPP to lend money to the sponsoring employer.
- It would be interesting to know why a SSAS was set up in the first place.
- If its holdings are as the case study states it is mainly collective investments and individual shares it is not making the best use of a SSAS futures
- Can take the benefits in the same way as a SIPP.
- It could provide a scheme pension (an actuarial calculation)

Helen's pension

- 8.6% annuity rate is very attractive
- Would give her a guaranteed lifelong income
- Which is potentially beneficial as she is in good health
- Jim could be the named second life

Treatment of her pension in her divorce

Note that the question is being asked from the point of view of the person giving up the pension rather than the recipient.

<u>Earmarking (attachment)</u>

- A court order that would pay a percentage of her pension when she takes it (presumably 65)
- He ex husband gets nothing until she takes the pension.
- It would be taxed as her income which may be disadvantageous to her ex husband
- It is not a clean break
- The court order may not affect the payment of a death benefit if she dies before retirement.
- It would probably have no effect on her GAR

<u>Sharing</u>

- A court order that directs her provider to pay part of her pension fund to her ex husband

- This is not pension input but will count towards her ex husband's lifetime allowance.
- It is a clean break
- It will reduce her pension
- It is more likely to mean that the GAR will be lost

My view is that nothing is put into the case study accidentally. In the fifth paragraph it says that they both draw a salary of £30,000 but Jim is paying himself £45,000 in dividends whereas Helen is not paying any due to difficult trading conditions,

Now this might be there to simply ask a question about salary v dividends or showing that Jim's business could fund a final boost to his pension but it might be testing something deeper. As a general principle, dividends can only be paid from profits so if Helen's business is performing badly she may be making losses and can't pay a dividend,

It's still possible to pay a dividend if you make a loss provided you have retained profits. We all know that in the real world businesses have been under pressure so if he has been extracting maximum dividends there may be no retained profits and next years planned dividend of £45,000 may be too high. HMRC would class this payment as a loan which must be repaid to the company in 9 months. If this is not done there will be a tax charge of 32.5%

I may be overthinking this but be prepared if it comes up.

Case study 2 Dante and Cara

Before getting into the stated objectives there are a number of issues around both their pensions that will impact on their stated objectives

- Dante's salary is £205,000 which is above the Threshold income for Tapered Annual Allowance. To that we would have to add his share of the rental profits and savings income.
- We are also told that his input for 20/21 is £71,000 which means he is going to be subject to an Annual Charge.
- However, we need to know the split between his and his employer's contribution.
- His contribution can be deducted from his salary in calculating threshold income.
- It will also increase his higher and additional rate threshold.

Explain how Dante's Annual Allowance would be calculated.

- His threshold income would be calculated.
- This is his Salary less his own pension contributions
- Plus his share of rental profits
- And interest from his deposit account.
- If this is less than £200,000 Dante will get the standard Annual Allowance of £40,000
- If this is more than £200,000 the Adjusted income must be calculated
- This is his salary (ignoring personal pension contributions) plus the employer input.
- The excess over £240,000 is divided by 2
- This figure is deducted from £40,000 but there would always be a minimum of £4,000

Explain how he could reduce his tapered AA.

- He should get his threshold income below £200,000
- He could put the investment property and bank account into Cara's name therefore all the rental profits and interest would be hers
- He could make further personal pension contributions but this would result in an increased annual allowance charge

Explain how any annual charge would be calculated

- The TPI in excess of £40,000 or the TAA would be charged at 45%.
- He could use carry forward to mop up the excess
- Going back three tax years although these may be restricted to previous TAA

- If there is still a liability Dante could ask the scheme to pay this charge provided the charge is more than £2,000 subject to the following conditions.
- Dante must have used carry forward to the maximum
- The excess must be due to an increase in his benefits rather than an increased personal contribution.
- The scheme can only pay the charge based on the excess over £40,000 not the TAA
- This must be done by July 31 2022
- His scheme benefits must be reduced to take account of this payment

His scheme seems a little odd

It says that he has been a member of the DB scheme for 32 years but academy schools weren't around then.
He has 32 years service but his pension as a proportion of his salary doesn't seem to reflect this. Possibly a career average scheme?

Ensure their pensions and investments are appropriate to their needs

This is a wide ranging objective and could be tested in a number of ways.

The key word is **appropriate**. To be appropriate their pensions and investments should:

- Be appropriate to their objectives.
- Be in line with their ATR
- Have an appropriate level of diversity
- Be held as tax efficiently as possible.

Comment on the appropriateness of their non-pension investments

- Rental income yield is 4.5% but this will be less when expenses are taken into account
- Dante is paying 45% tax on his share of the rental income and deposit interest and could make him subject to the TAA
- If the property is sold they will pay CGT on the gain at 18% and 28%
- No equity exposure therefore lack of diversification and it does not match their ATR.
- The commercial property fund may be illiquid.
- Their investments are mainly in ISAs
- Cara's unit trust produces savings income and part will probably be taxed at 40% with a PSA of £500
- Too much on deposit/does not match ATR

What additional information would be required to give advice on the appropriateness of their non-pension investments.

- What are their financial objectives, income or growth?
- Capacity for loss.
- Acquisition price of their assets.
- Have they used the ISA allowance for this year?
- Income provided from their investments
- Expenses involved with the rental property.
- Charges

Some possible improvements

- Switch deposit account and rental property into Cara's sole name.
- Should consider switching ISA into a broader range of assets with more equities and non-UK exposure
- Cara should switch £20,000 of her unit trust into an ISA and repeat each year.
- She could also transfer £20,000 of cash to Dante so he could use his ISA. (Transferring the Bond fund wouldn't work as being a intra spousal transfer when Dante encashed then to transfer into an ISA the base cost would be what Helen paid for them)
- Cara should invest her savings account into a wider range of equity based assets

It could be useful to look at Q2 (f) of the February exam on the benefits of switching cash to equities.

Comment on the appropriateness of their pension investments.

- Dante is in a final salary scheme
- Will give a guaranteed inflation proofed pension
- If current TPI continues he will have to pay AAC each year
- His projected pension is in excess of the current LTA (20 x £52,736 = £1,054,720 + £124,750 = £1,179,470
- Scheme retirement date is 67 could be an actuarial reduction if he retires earlier
- Projected pension seems low for his length of service and salary
- Cara's balanced managed fund does not seem to match her ATR
- The With Profits fund does not match her ATR
- Emerging markets may be too high a risk.

Additional information on pension

- When do they plan to retire
- Required income

- What is Dante's contribution?
- What unused allowance does he have from the past three tax years?
- What is the penalty for early retirement?
- What is the escalation rate (you might get a mark for asking to see the scheme booklet)
- Scheme funding and employer strength
- What is the split of Cara's balanced managed fund?
- What alternative funds are available?
- With her deferred pension what is the split between the emerging markets and WP fund?
- Is the WP fund conventional or unit linked.
- If the former what is the bonus rate?
- What is the asset split of the WP fund,
- Current value
- Is there an MVR being applied?
- Are there any MVR free dates?
- Fund charges

Technical note Dante and the LTA

- His projected pension is in excess of the current LTA.
- This does mean it is not worthwhile continuing in his pension scheme.
- No way of telling what LTA will be when he takes benefits.
- His pension rights should be monitored on an annual basis

Explain why should Cara switch from the WP fund in her pension?

- It does not match her ATR
- It is probably invested mainly in gilts and bonds.
- When she wants to take the benefits an MVR may apply.

- **Technical note With Profit Fund**

- These can be traditional or unitised
- Traditional have a guaranteed SA payable at maturity date
- Each year the company may declare a bonus that increases the guaranteed amount.
- Once declared it cannot be removed
- A terminal bonus may be added at maturity.
- In a unitised fund the fund is split into units.
- These do not necessarily reflect the value of the underlying assets
- Each year the company may announce an annual increase in the value of the units, say 3%, which is applied daily.

- When Cara wishes to encash her holding she may not get back the full value as a Market Value Reducer may apply.
- There will probably be some MVR free dates when it won’t be applied

Ensure they have adequate financial arrangements in place.

Identify the factors relating to Dante and Clara's current circumstances that should be taken into account by a financial adviser to give advice on ensuring that they have adequate financial arrangements in place

- They have two dependant children.
- They may have to financially support Cara's mother.
- They are both in good health
- Dante is the major earner therefore major risk is that he is unable to work or die
- Dante gets a death in service benefit of £615,000
- Probably a spouse's pension for Cara and children
- Cara has a death in service benefit of £100,000
- Dante would get sick pay for 100 days (about 14 weeks) and half pay for a further 100 days.
- Dante has an Income protection policy.
- Cara would only receive 4 weeks sick pay then SSP
- They have an outstanding mortgage of £250,000 on an interest only basis to be repaid in 15 years
- They have gross rental income of £9,000
- They have liquid assets of £468,500
- They have a joint life first event CI and life policy with a SA of £100,000
- State benefits likely to be minimal.
- SSP in Cara's case is not means tested but would not get Universal Credit in view of their assets
- No PMI

State the additional information you would need to give advice on Dante's existing income protection policy and their Critical Illness policy

<u>Income Protection</u>

- Monthly benefit
- Deferred period
- Does it have an escalation benefit for both cover and in payment.
- Expiry date
- Premium. Amount plus is it guaranteed or reviewable,
- Definition of job
- Can the benefit be increased or will a new policy have to be taken out?

Critical illness

- Definition of critical illnesses
- Guaranteed or reviewable premiums
- Current premium
- Maturity date
- Increase options
- Affordability

Recommendation and Justification question.

- They have a reasonable amount of cover.
- Their major gaps are:
- An increased life cover to pay off the mortgage
- Depending on the extent of Dante's IP policy, this may need to be increased

Most probable question would be on a Family Income Benefit Policy for Dante

- **Family Income Benefit (FIB)** policy on life of Dante taken out in Cara's name to ensure speedy payment
- Monthly amount equivalent to monthly outgoings to maintain standard of living.
- Term for minimum of 8 years to take youngest child past higher education/until planned retirement age.
- With Indexation to ensure it keeps pace with inflation
- With WOP to ensure premiums would be paid if unable to work due to accident or sickness
- Guaranteed premium to give certainty

Suitable strategy to repay the mortgage

There are three main options.

- Do nothing and repay as planned in 15 years
- Sell the rental property and/or encash other investments to pay off all or part of the mortgage
- Switch to repayment

Do nothing

Pros

- Their outgoings won't change
- They have adequate assets.

Cons

- Incurring interest costs for another 15 years
- May be a market drop before then
- May have to use his pension PCLS

Paying off the mortgage with existing assets

Pro's

- They would have more disposable income
- Saving interest payments may be more than rental profits.
- Need lower insurance to cover the mortgage
- Easier to bring Dante's income below the Threshold Income

Cons

- Loss of rental and investment income
- Costs of selling the property
- Will be a CGT disposal and tax will be payable

Moving to repayment

Pros

- Guaranteed to be repaid.

Cons

- Higher monthly costs

Lasting Power of Attorney

We are told that Cara is keen to ensure that her mother's interest are appropriately protected and there are no legal arrangements in place. This leads on to Lasting Powers of Attorney.

Questions on LPA's could come in a variety of forms so the best preparation is to understand the key points of an LPA.

- An LPA will ensure that Cara or another person can take over her mother's financial affairs and/or make welfare decisions if she loses mental capacity.
- Cara sets up the LPA and appoints her attorney (ies)
- It must be done on the prescribed form.

- It must be signed dated and witnessed.
- It can be for finance or welfare or both.
- She can ask for five other people to be informed when the form is submitted to the OPG
- It must also be signed by an independent third party (the certificate provider) who confirms that her mother knows what she is doing.
- It is sent to the Office of the Public Guardian who will register it.

- Her mother would probably want to appoint Cara as her attorney.
- She should also consider appointing a deputy who could take over if Cara died or became incapacitated.
- Once registered it can be used.
- Whilst her mother retains mental capacity the attorney can only give supported decision making (that is help her mother make a decision but cannot overrule her mother)
- Once she has lost MC she can give substituted decision making (that is taking decisions on behalf of her mother)
- If it is for personal welfare, decisions can only be taken by the attorney when her mother loses mental capacity.

- If an LPA isn't completed and her mother loses mental capacity then Cara would have to apply to be a deputy
- She would have to apply to the Court of Protection.
- It is an expensive process and Cara's application may be rejected.
- If appointed Cara's powers would be more restricted than an LPA
- She would have to submit regular returns to the COP

- The £300,000 gift made by her mother is significant.
- It would have been a PET and would become exempt in two years time
- But if her mother goes into a care home the local authority would probably consider this as "deliberate deprivation of assets".
- Therefore would be unlikely to get financial assistance and would have to pay all the fees themselves.

Final Review question

- Any changes in personal situation
- Any changes in financial situation
- Any changes in objectives
- Change in ATR/CFL
- Review investment performance, rebalance
- Use available allowances (ISA Pension CGT)
- Change in taxation or legislation

- Review current economic situation
- New products available