R06 case study April 2022 Version 1

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 Harry and Mia

Key Facts

- Both 61 and are married
- Plan to retire in two years time when they are 63
- Two adult children and five grandchildren.
- Mia suffers from MS and the condition has deteriorated in the past two years.

- Harry is self employed and has profits of £78,000
- Mia has not worked for two years
- She gets state benefits of £7,911
- No mortgage and no liabilities.
- No protection policies other than a PMI policy.
- Mia will shortly inherit £155,000 of unit trusts from her late father
- They have substantial non-pension assets
- They have not used their ISA allowances in the last two tax years
- Medium risk investors
- Interested in SRI investments

Objective: ensure that they have an adequate income in retirement

Known facts

- Plan to retire in two years time.
- Harry has an **Executive Pension Plan** which is invested in a with profits fund
- Contributions ceased in 2007 following the employer's liquidation
- Current value £480,000
- Guaranteed Bonus rate of 4.7%
- Guaranteed annuity rate at plan's retirement age of 65
- He contributes to a PP with a current value of £182,000
- Mia has a PP with a value of £84,000
- She has a deferred DB pension projected to provide a pension of £3,600 at 65

- They have non-pension assets worth £1,160,000

Additional information question

Note that to get marks for this type of question the points in your answer must:

- Be information not given in the case study.
- Seek to get hard facts (not questions such as, "have you thought about…", "what would happen if……?"

- What income/capital do they need in retirement?
- Split between essential and discretionary spending.
- What is the guaranteed annuity rate on his EPP?
- What is the window to exercise this?
- Is an MVR currently in operation?/Is there an MVR free date?
- What contributions is Harry making into his PP?/contribution history
- What is the selected retirement date
- Willingness to increase contributions/affordability
- Harry's health
- What State benefit is Mia receiving?/will he be paid after State Pension Age?
- What is Mia's prognosis?/Life expectancy
- Where is Mia's PP invested.
- What is the spouse's pension from Mia's DB scheme?
- What is the early retirement penalty for her DB pension?
- Would the scheme allow an ill health pension to be paid?
- What income is being produced from their investment portfolio?
- Would they prefer a guaranteed or flexible income?
- Would they prefer to take income from pension or no pension assets?
- Do they want to take income in the form of capital withdrawals?
- Do they have a state pension forecast?
- Do they plan to downsize/move to another property?

What factors would you consider in drawing up a strategy?

A "factors" question asks you to list all the facts that you would take into account before you draw up a plan. This includes facts that are already known

- They plan to retire in two years time
- Their need for income and capital in retirement
- Mia will probably have a reduced life expectancy./Could qualify for an impaired life annuity/Could qualify for an ill health pension from her DB scheme
- State pensions will be paid from 67

- Harry's pensions are all money purchase with funds of £682,000
- His lifestyle strategy fund is not in line with his ATR and may not be suitable if he wants to take benefits flexibly
- There is a two year gap between 63 and making use of the GAR and Mia's DB
- The guaranteed annuity rate on the EPP may be higher than current market rates.
- The EPP may have a protected PCLS
- Harry can use carry forward to make a final boost to his pension
- Mia's contributions will be restricted to £3,600
- They have substantial non-pension assets.
- They have not used their ISA allowance
- They have no liabilities
- The need for inflation protection.

Retirement strategy

They have a range of options to fund their retirement and you can expect to get questions on these. It will be helpful if we take an overview of the decisions that need to be taken over the next four years.

Pre-retirement

- Harry has an opportunity to boost his pension by maximising his contributions whilst he is still working.
- Potentially he could contribute another £156,000
- This increases his pension fund giving him a higher pension and PCLS
- It would also get 40% tax relief on most of this but when he takes the benefits it will probably be taxed at 20%
- To maximise tax benefits his annual TPI should be limited to £40,300 as this would mean he would only be taxed at 20% on his whole income
- Depending on the selected retirement age his PP may be derisking, switching from equities to Bonds.
- This is suitable if he is going to buy an annuity but less so if he wants to take benefits flexibly.
- If the latter is the case then he should switch the fund to one which is more equity based.
- Mia could contribute £3,600 gross to her PP.
- This is advantageous as she will get basic rate relief and may not be a tax payer when she takes the benefits.
- Having got a State Pension Forecast she could consider making Class 3 contributions to make up any shortfall
- She could also ask if her DB scheme would give her an immediate ill heath pension.

Ill health pension

Mia qualifies as:

- She has ceased work
- She can provide medical evidence that she will not be bale to work again

- The pension will probably be paid without an actuarial reduction and may be at the projected benefit of £3,600
- She could take part of it as a PCLS
- But it would mean she has lost the option of a possible transfer

Decisions at 63

This is when Harry wants to retire

His first decision is whether to take an income from his PP (note not his EPP) or use their non-pension assets, either by taking income or taking capital withdrawals.
If he decides on the pension route, he must then decide whether to take benefits securely or flexibly.
Mia could also decide to crystallise her pension.

Technical note Executive Pension plan

- This is an occupational money purchase scheme
- He cannot make any further contributions
- As it must have started before April 2006 it will have a protected PCLS greater than 25% of the fund
- But this would be lost if the fund was transferred.
- The 4.7% return looks reasonably generous
- The guaranteed annuity rate may be attractive but could only be exercised at 65.
- The fund value may be reduced by a Market Value Reducer if taken before 65.

Pension or non-pension

- Crystallising the pension would release the PCLS
- Could take a regular income either securely or flexibly
- Can crystallise part and leave remainder uncrystallised.
- But income would be taxable
- Leaves other assets intact with further potential growth.

- Income from ISAs would be tax free
- Income from other sources could use their dividend and PSA
- Income in Mia's name would be mainly tax free.

- If they encash some of their non-ISA investments, they could make use of their CGT exemption and give them an "income" of £24,600 tax free.
- Encashing investments reduces the value of their estate and IHT
- Uncrystallised Pension funds are outside the estate and could benefit from potential growth.

Secured or flexible benefits

This decision will apply whenever they decide to crystallise the benefits.

<u>Annuity</u>

- Simple process
- Gives a guaranteed lifetime income
- No investment risk.
- No post sales administration.
- Mia would qualify for an impaired life annuity.

- Lock into annuity rates at outset which may be poor.
- Must decide on all options at the outset, cannot be renegotiated
- Guarantees can be built in but may provide poor value if he dies earlier than expected.
- Providing inflation protection is expensive

<u>Flexible (drawdown)</u>

- Can crystallise whole fund or just part
- Release PCLS and remainder goes into drawdown
- They could take out what he wants, when he wants
- Can vary income as he requires
- Any funds in drawdown can be passed to designated beneficiaries which could include the children
- Remaining funds would be outside the estate
- Benefits would be tax free to survivor if he died before 75

- Incurs much more admin
- Will incur fees
- Fund may be exhausted

Decisions at 65.

Harry should now take the EPP using the GAR

Mia could take her DB pension (although she could have taken it earlier as an ill health pension) but a further option would be to transfer it to a PP. This could have been done at any time.

Benefits of taking the pension

- Provides a guaranteed lifetime income
- This will have some inflation protection
- Will give Harry a pension if Mia dies before him
- No admin on her part.

Drawbacks of pension

- Mia's reduced life expectancy may mean she gets little benefit
- Harry's spouse's pension will be taxable no matter when Mia dies
- Her pension will not take account of her ill health.

Benefits of transferring

- If she transfers and buys an annuity she could benefit from an impaired life annuity
- Otherwise ,the benefits and drawbacks are similar to annuity v drawdown.
- BUT one major consideration is that she must get regulated advice which will be expensive.

Decisions at 67

- This is when state pension will start
- This is index linked and guaranteed for life
- Deferment is possible but will be poor value as it is based on an annual increase of about 5.2%

- Mia may qualify for Attendance Allowance at SRA if she needs help in caring for herself.
- This would be either £61.85 or £92.40 a week depending on her condition.
- This would be tax free

Review their investments and plan for the receipt of Mia's inheritance

Known facts

- Excluding the current account they have £1,160,000 of assets
- £122,000 is in cash based assets (including £50K premium bonds)
- £340,000 is held in ISA. These are all in gilt/bond funds
- They do not appear to have investments that match their SRI
- Gilt, Bond funds do not match their ATR
- They have not used their ISA allowance.
- Bank shares have probably not performed well.
- We know nothing about the General Investment Account

Discretionary Managed Portfolio

- What is the asset split of this fund?
- What is the mandate of the fund
- What income is being produced?
- What are the charges?
- What is the recent performance?
- Is it run on an advisory or discretionary basis?
- Why haven't the managers used their ISA allowances.

They state that they are looking to generate an appropriate level of investment income so the first issue is to assess if this is feasible on the current portfolio.

- Little known about the DMF
- Their ISA funds are in Gilts and Bonds so will be biased towards income rather than growth
- Potentially some inflation protection as Mia's fund contains some index linked gilts
- Both contain CB so some risk of default

Action required

- Review the DFM portfolio for asset split, charges and performance to establish its cost effectiveness.
- What benchmark has been set
- Establish an asset split for the whole portfolio
- Consider switching some of the bond funds into equities
- Have a more geographic spread
- Both should use their ISA allowances to the full.

- Income producing assets should be in Mia's name as she pays tax at a lower rate
- Some assets should be held in SRI

Pros and Cons of SRI.

- No set definition of what is an SRI
- Most common approach is negative screening
- But this can result in some defensive stocks (tobacco) being excluded that could result in a lower performance.
- Positive screening may result in investing in smaller companies

Inheritance of unit trusts

- Establish what funds these are.
- Include them in the overall investment plan

Consider an IHT mitigation strategy to ensure their estate passes to their two children in a tax efficient manner

- No mention in the case study as to whether they have made wills.
- If not they should do so as dying intestate would mean that not all of Harry's assets would not go to Mia.
- Total assets are currently £2,138,500 so on second death the RNRB would be tapered.
- The position is likely to get worse as the RNRB is frozen until 2026 and is then only expected to rise in line with CPI and increase in house price and other assets may be higher.
- Overall they should take capital from non-pension assets as pension assets are exempt from IHT
- Income should be taken from the ISA as tax free
- Should consider using all possible exemptions,
- The £3,000 annual allowance
- Charitable legacies to get 36% rate
- PET could be made by Harry but not by Mia in view of her possibly reduced life expectancy
- Possible use of DGT

Discounted Gift Trust

- This could provide an income whilst at the same time reducing the IHT liability
- It probably shouldn't be set up until Harry retires since income isn't currently needed.

- It should be made by Harry rather than Mia in view of her ill health.
- Harry would make a gift into the trust
- This would be split into two, a discount and the remainder.
- The discount would be based on the donor's age and health (hence why Mia should not make the gift}
- The discount would be immediately outside the estate
- This would be placed in an Investment Bond which would provide a regular income using the 5% withdrawal.
- It is important that this is spent rather than being saved, hence why it may be best to not start the trust until Harry retires
- The remaining amount is placed into a Discretionary Trust.
- It would be exempt after 7 years (another reason why Mia should not make the gift)
- Mia could be a beneficiary so if Harry died first the trustees could make payments or loans to her.

Lasting Power of Attorney

- In view of her medical condition Mia should consider setting up a Lasting Power of Attorney.
- This can be done as she has mental capacity.
- It must be done on the prescribed form
- Harry could be her attorney with one of the children as replacement attorney in case Harry dies or becomes disqualified.
- It can be for Personal/Finance and/or Welfare.
- It must be signed, dated and witnessed. It must also be signed by an independent person (the certificate provider who has known Mia for at least two years.
- It must be registered with the OPG
- Harry could then take decisions for Mia if she were to lose mental capacity.

Case Study 2 Matt and Emma

Key Facts

- Both 35, unmarried with no intentions of marrying
- Two children, 5 & 3
- Repayment mortgage of £160,000 on a house with a value of £300,000

- Matt earns £65,000
- Member of his qualifying pension scheme to which he contributes 5% (£3,250) which is matched so TPI is £6,500
- Current value £80,000 in the scheme's default scheme
- 4 times DIS (£260,000)
- Two months basic pay then SSP only

- Emma basic £35,000
- Pension scheme, she contributes 5% (£1,750) with 3% from employer (£1,050) therefore a total of £2,800
- Cautious managed fund £40,000
- No DIS
- Four weeks sick pay then SSP
- High risk investors no strong ethical views

- They have £77,000 on deposit
- £62,000 between them in ISA

Ensure their protection arrangements are both suitable for their needs

Comment on their current situation

- There doesn't appear to be any life cover on the mortgage
- Matt's DIS would give £260,000 so would give a short term benefit
- Emma has no DIS
- Sick pay arrangements for both are poor and once SSP runs out they would get very little in UC
- Living standards likely to be affected if either were to die
- They have not made a will which means apart from the house and the current account, their assets would go to the children and not to the survivor

Additional information

- Current outgoings
- Childcare costs/are they making use of the any government schemes
- Income required if either were to die
- State of health/smoker status/dangerous hobbies
- Willingness of parents to offer support in the event of either death
- Cost of mortgage/interest rate
- Remaining term of mortgage
- Planned retirement age/dependency of children
- Nominations for death benefits/pension funds
- Affordability
- Views on inflation
- Any plans for further children?

Recommend and Justify

- A decreasing term policy
- For £160,000
- In joint names, first death basis
- With a term linked to existing term
- To ensure mortgage is paid off in the event of either death
- With Critical Illness on first event basis
- Waiver of premium to ensure premiums can still be paid if unable to work due to illness or accident

If asked to **recommend and justify** a policy to provide a lifetime income for either, you should use the following template: (remember one mark for the recommendation and one mark for the justification)

- Family income policy
- Taken out by (name the person)
- On the life of (name the other person)
- To ensure speedy payment/avoid probate
- For £x a month (the marking scheme is flexible any figure around 50% to 70% of gross pay)
- To maintain survivor's living standards.
- With a term of x years (either to youngest child 18/21/planned retirement age)
- To ensure income continues whilst at most vulnerable
- With indexation
- To maintain real spending power
- With waiver of premium

- To ensure premiums can be maintained if the planholder is unable to work dues to accident or sickness
- Guaranteed premiums to maintain affordability

The October 2020 paper had a question on the benefits of taking out an FIB policy

- Tax free income
- Select SA to meet lifestyle needs
- Term to match their needs
- Low cost cover
- Speedy payment if written on life of another basis or in trust
- Guaranteed premium
- Gives peace of mind
- Indexation available
- Simple underwriting
- Cannot be cancelled by the insurer

To protect against long term sickness the most suitable product is likely to be an **Income protection policy**

Again if asked to recommend and justify the following template could be used:

- Income Protection Policy
- Taken out by (Matt or Emma)
- With a monthly benefit of (any monthly figure between 50% and 70% of gross pay will probably be acceptable)
- To maintain standard of living
- Deferred period of 8 weeks for Matt and 4 weeks for Viktoria
- to match their sick pay from their employers.
- Term to planned retirement age
- To give lifelong cover.
- Own job basis
- to maintain widest cover.
- With indexation
- To provide protection against inflation
- Proportional cover
- To give cover if unable to work full time
- Guaranteed Premium to ensure affordability

Note that the cost could be reduced if they could accept a longer deferred period but this would depend as to whether they could financially cope with the drop in income between the end of sick pay and the IP kicking in.

Technical note Statutory Sick Pay

- This amounts to £96.35 a week
- It is payable for up to 28 weeks
- It is paid by the employer.
- After that they could get Universal Credit but may not get full amount as it is means tested.

Dying Intestate

- The house and joint account would go to the survivor under joint tenancy rules
- All other ISA would be held in trust for the children until they are 18
- Therefore important that they make wills
- To ensure assets pass to the survivor
- Could also set up guardianship arrangements for the children

Improve their long term savings arrangements

Note: this will include their pension arrangements

- How have current savings been funded
- What are they currently saving, if anything?
- Do they have any specific plans for their savings?

- Their current assets are tax efficient as they are in an ISA
- They match their ATR
- But perhaps could have other types of assets.

- Emma's pension fund do not match their ATR
- Need to know details of Matt's fund

- Return on BTL property is only 6.66%

Improve the tax efficiency of their current arrangements

- On the face of it there seem to be few issues
- They have ISA
- Only taxable income is Emma's savings account but the interest is likely to be within her PSA
- Tied in with the objective of improving their long term savings and their high risk approach they could consider EIS/VCT

- EIS invest in new shares for new small businesses
- VCT are a pooled investments in unlisted companies but tax relief is only available on new issues.
- Tax relief of 30% is given as a tax reducer but cannot exceed the investor's tax liability
- EIS must be held for three years otherwise tax relief is withdrawn.
- CGT free after three years
- But are illiquid
- And high risk
- Can offset losses against income tax
- VCT similar but must be held for five years

- This objective does not just refer to tax efficiency of their investments
- Currently not getting tax relief as Matt's ANI is £61,750
- Could get it below £60,000 by making further pension contributions.
- Could also consider salary sacrifice by exchanging salary for employer pension contributions
- Saves him 2% NIC
- But employer may redirect employer NIC to increase contribution
- If ANI could be reduced to £50,000 they would get all Child Benefit back
- Is this affordable?

Help with childcare

There is no mention in the case study of them getting any help with childcare so there may be questions on this, They could be eligible for two benefits:

- 30 hours free child care
- Tax free childcare

30 hours free child care

- This could be claimed for James but not Cora (child must be 3 or 4)
- They are both working and earning more than the minimum wage
- Neither has an ANI of more than £100,000

Tax free Childcare

They could open an on-line account with HMRC and for every £8 paid in by the parent the Government will add £2. The maximum amount that can be placed in the account is £10,000 for each child that is £8,000 parental contribution and £2,000 government subsidy.

The account is then used to pay the cost of childcare. The parent will tell HMRC who is the provider and the payment will be paid directly to them. This works out as a maximum contribution of £500 every three months.

They are eligible because:

- The children are under 11 (they stop being eligible on 1 September after their 11th birthday.)
- They are living with the parent.
- They are both working
- They are earning at least at least the minimum living wage over the next three months based on working 16 hours a week on average.
- Neither has an adjusted net income (see part 4) over £100,000.
- Matt has been self-employed for more than 12 months ago.
- Although only a parent can open the account, anyone can pay in including grandparents.
- Money can be withdrawn from the plan for other reasons but the government subsidy will be removed.

Inherited Buy to Let Property

- Could be a couple of curved ball issues here
- Is it wise to give it in joint names as this would cause potential problems if they divorced?
- More tax efficient if BTL property was in Emma's sole name as she is a basic rate tax payer.
- Could be a bit of a "white elephant" as they will be responsible for ongoing costs and yield is only 6.66%
- Would incur costs on disposal and CGT charged at 18% or 28%.
- The gift would have been a PET from her father but if previous gifts had used up his NRB and he dies within 7 years they could be liable to tax at 40% although this could be reduced by taper relief
- If this is the case, they could check if her father is willing to be insuered for the amount of tax that would be due using a gift inter vivos policy.

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