AF5 May 2022

These notes aim to cover all the key points arising from the May fact find. 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

Overview

- Mike and Emma Rees, 55 and 53 respectively
- Children independent
- They both plan to retire in 10 years' time when Mike will be 65
- Following the death of Emma's father they wish to review their financial position.
- They are high risk investors
- They have a high capacity for loss

Strengths

- Children financially independent
- No mortgage or other liabilities.
- Combined gross salaries of £84,000 (£54K + £30K)
- Mike's firm will be setting up a Share Incentive Plan
- Dividend income of £6,250
- Surplus income of approximately £1,400 a month
- Mike has DIS of £162,000 and Emma £90,000
- They have a level term policy for £175,000 runs until 2027
- They have PMI which is currently costing £2,800 a year
- Excluding their current account they have £397,000 of savings and investments
- £157,000 of this is in ISA
- They don't need to spend the dividend income
- They are investing £400 a month into a UK tracker trust which now has a value of £80,000. They can afford to increase this.
- Mike has £185,000 in his workplace pension
- Emma has £148,000 in her workplace pension
- Emma has an inherited SIPP which is all in cash with a value of £180,000
- They have made mirror wills
- They have a high capacity for loss.

Weaknesses

- Mike has recently been diagnosed with high blood pressure that has implications if he requires further life/sickness protection. It will also be an important factor in deciding whether to retain their PMI.
- Although they are mortgage free and children are independent the death of either may impact on their plans for later life.
- They have planned capital expenditure of £100,000
- Some of their holdings are above the FSCS compensation limits.
- The IT is not in an ISA and has a potential gain of £65,000
- Lack of diversification, no bond exposure
- Mike has taxable dividend income of £5,000 so £3,000 will be taxed at 32.5%
- The premium for PMI is increasing each year.
- The pension funds are relatively low with only 10 years to go.
- Benefits from Emma's inherited SIPP will be subject to income tax as her father was over 75 when he died.
- Their State Pension Age will be 67 so Mike will receive it in 2034 and Emma in 2036
- They don't have Lasting Powers of Attorney.
- No inheritances expected in the immediate future
- Total estate currently £1,069,000 so there is a potential IHT liability

Possible objectives

These will be given to you in the exam. It won't be the end of the world if there is something unexpected or written in a different way but these are some possible ones

- To identify a suitable way to finance the £100,000 capital spend
- To advise Mike on the merits of joining the Share Incentive Plan.
- To review the suitability and tax efficiency of their investments.
- To ensure that they will be able to retire with an adequate income.
- To mitigate their IHT liability

Of these their objective to retire in 10 years' time with an adequate income is likely to be the main priority and most challenging. This will not only be concerned with their existing pensions but also include their savings and investments

Mike and Emma have reached a stage in life where the outlook is very good. They have paid off their mortgage and the children are independent. This has resulted in them having surplus income and they can focus on ensuring that when they stop work they have a comfortable lifestyle.

However, their plans could be upset if either were to die in the next 10 years so whilst protection may not seem a priority it needs to be explored.

Comment on their current protection arrangements

This type of question is testing your ability to analyse their situation to establish whether they have a need for financial protection.

- Both have DIS. £162,000 for Mike and £90,000 for Emma
- They do not intend to leave their current employer therefore these can be seen as a permanent part of their protection package.
- This will increase as their salaries increase
- They have a joint life policy which would pay £175,000 but this will terminate in 2027
- Their wills leave everything to each other

- Mike is the major earner
- With outgoings of £41,000 this is covered by Mike's salary and investment income.
- However Emma's salary of £30,000 would be insufficient to meet the outgoings even with her investment income of £6,600. Living expenses may of course reduce following Mike's death.
- She would receive Mike's DIS of £162,000
- Plus the proceeds of the life policy should he die before 2027
- This is a total of £335,000 which could give an income of about £13,000, a possible total income of £49,000 which would be sufficient to meet the outgoings.
- This though may result in her having sufficient disposable income to boost her pensions.
- The survivor would have assets of £397,000 in assets.
- Boosted by the death in service benefits
- They would each get an Additional Permitted Subscription (APS) for the deceased's ISA so investments can still enjoy the tax privileged benefits

Pension rights on death

- They have nominated each other for their pension funds and benefits would be tax free if they died before 75
- They would have the option of taking the benefits as a lump sum, buy a dependant's annuity or dependant's drawdown.
- No minimum age to exercise these.
- They appear to have no protection against being unable to work due to accident or sickness
- This could be significant for their retirement plans as with no Net Relevant Earnings pension input would be restricted to £3,600 gross.
- Even if they have Income Protection insurance, this would not be classed as NRE

On reflection I think it is unlikely that you will be asked to recommend a policy to protect either if the other should die. Should it come up you could use the following template.

- Family income Benefit policy
- Taken out by Emma
- On the life of Mike
- To ensure speedy payment/avoid probate
- For £3K to 6K a month (the marking scheme is fairly flexible)
- To maintain Emma's living standards by covering any income shortfall.
- With a term of 10 years to planned retirement age
- To ensure her retirement plans are met
- With indexation
- To maintain real spending power
- With waiver of premium
- To ensure premiums can be maintained if she is unable to work dues to accident or sickness
- Guaranteed premiums to maintain affordability

There is also the risk of either becoming unable to work because of serious illness or accident. There is no mention of any sick pay benefits from their employers. This would need to be established before we could give advice.

An income protection policy would protect them but this is likely to be expensive. However, in the exam you can recommend anything regardless of the cost!

- Income Protection Policy
- Taken out by Mike (or Emma depending how the question is phrased)
- With a monthly benefit of (any monthly figure between 50% and 70% of gross pay will probably be acceptable
- Deferred period to match employer's sick pay period
- Term of 10 years to planned retirement age
- To ensure their retirement plans can be met
- 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

Retirement Planning

One of these two questions is probably going to be asked:

Identify the additional information *that you would require to enable you to assess the suitability of Mike and Emma's existing pension arrangements to meet their retirement objectives*
Outline the key factors *that should be taken into consideration when establishing if Mike abd Emma have sufficient funds to meet their long term income requirements*

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……?")

- Are you flexible on retiring at 65?/willing to retire later?
- Income and capital required
- Views on inflation
- State pension forecast
- Expected salary rises in next 10 years
- Will the employer allow you to increase your contributions?
- Will these be matched?
- Contribution history
- Full holdings in the UK managed fund and the Global Equity ETF
- Percentage of each fund, e.g. 50/50
- What indices do their tracker funds follow?
- What other funds are available?
- Past performance
- Recent forecast of projected value in 10 years' time
- Charges?
- What is the death benefit/Return of Fund?
- Is there a waiver of premium?
- Are funds automatically switched as you approach retirement age?
- Does the employer allow salary sacrifice?
- Would they rebate any employer NIC?
- Does their funds have an enhanced PCLS?
- Willingness to use investments to fund their pensions or use them as income in retirement
- Preference for regular contributions or lump sums?
- Have they used their ISA allowance this year.

- Were the schemes contracted out of SERPS/S2P?
- Affordability

Outline the key factors would you consider in drawing up a strategy?

A "factors" question asks you to list all the facts that you would take consider in drawing up a plan. This includes facts that are in the case study

Some of the AI questions can be transposed

- Income and capital required
- Inflation expectation
- They are 10 years from their planned retirement age therefore short investment horizon, may have to take a more cautious attitude which could result in a lower performance.
- Current values are inadequate to provide a reasonable income in retirement
- Funds lack diversification (all equities) and are mainly trackers therefore may not match attitude to risk.
- Mike's annual input is £5,400 and Emma's is £3,000, therefore they have unused allowance for the current year
- Mike could use carry forward
- Their funds may have a protected tax free cash
- They will inherit each other's pension funds
- Emma has an inherited SIPP (nominee's SIPP) with a fund value of £180,000 but all withdrawals from this will be taxed under PAYE as he died over 75
- This is all in cash so needs to be reinvested to get greater growth
- They have £397,000 of non-pension assets
- Some of these may be earmarked to pay for the house extension
- They have disposable income and could redirect the £400 a month that was previously being used to fund the Unit Trust
- State pension age for both will be 67 This is two years for Mike and four years for Emma after when they plan to retire.
- There is a risk that if either cannot work due to long term sickness or disability, their ability to fund their pensions will be restricted to £3,600 (gross)

State Pension Entitlement

- Both will qualify for the Single Tier Pension provided they have at least 35 years contributions or credits
- Emma would be entitled to credits for the years she was claiming Child Benefit.
- They may both have a Pr0tected Element for any SERPS/S2P benefit accrued before April 2016
- This will be increased by CPI until State Pension Age (67)
- The survivor can get 50% deceased's Protected Element no matter what age they are.

- They cannot inherit the STP

Strategy

First need to identify funding gap

- Establish income required in 10 years' time based on today's situation
- Revalue by assumed inflation to then
- Assume a 4% withdrawal (either by annuity rate or Safe Withdrawal Rate)
- Calculate capital sum needed
- Calculate shortfall between this and projected value of existing workplace pensions

Then develop a strategy.

- Their objective should be to try and boost their pension over the next 10 years.
- This can be achieved by a combination of increasing/maximising contributions AND taking a more aggressive investment strategy.
- However, the latter may not be sustainable as a fall in the years ahead of retirement would mean that retirement would have to be postponed
- Increasing contributions would get up to 40% relief for Mike and 20% for Emma.
- This increases their pension fund, potentially higher income, PCLS and death benefits
- Review what other funds the employers offer.
- Rebalance their work place pensions to have a wider diversification and include some bond funds to provide negative correlation
- Increase their contributions to the maximum scheme allows to get benefits of lower charges and possible matching.
- Utilise their ISA allowances each year.

Benefits of additional contributions their workplace pension and a separate PP/SIPP

WPS

- Fund charges may be lower
- Employer may offer matching contributions
- Money taken directly from their salaries

BUT

- Fund range may be limited
- May be a cap on maximum contributions.
- May only allow changes in contributions once a year
- Not possible to make lump sum/one off contributions
- No WOP so contributions restricted if unable to work.

- May have to transfer to take benefits flexibly

PP/SIPP

- Wider range of funds
- More flexible contributions/can increase or decrease/make lump sum payments
- Can include Waiver of Contributions for regular contributions which gives protection against being unable to work and restricting pension input.
- Easier to take flexible benefits.

BUT

- Possibly higher charges
- No matching contributions

Some action they could take immediately

- Cease contributing to their tracker unit trust and redirect into their pensions to increase fund
- Also more tax efficient that putting money into an ISA as would get tax relief
- Putting £200 a month each is £250 gross or £3,000 gross
- This would take Mike out of higher rate tax
- Unlike a unit trust no tax on income within the fund and growth is free of CGT
- Emma's nominee's SIPP should be switched from cash to get higher potential growth.
- She should nominate Mike as the successor
- Decisions on how benefits can be taken can be deferred until they need to draw on this.

Explain to Mike and Emma why they should make further contributions to a new PP/SIPP using regular rather than lump sum contributions.

- Savings discipline
- Benefit from volatility/more units bought in a falling market
- Avoids market timing risk
- Contributions can increase/decrease/flexibility
- Reduces risk of investing in higher risk funds
- Averages cost of unit purchases
- Can include waiver of contribution to maintain contributions if they are unable to work and have no NRE

Reviewing their savings and investments.

Questions on the subjects' savings and investments are the hardest to predict as they vary widely from one exam to another. However in any question that asks you to review the subjects' S & I you should consider:

- Is there sufficient diversity?
- Are the investments tax efficient?
- Are they in line with their objectives?
- What is their performance?
- Are they appropriate for their risk appetite?

The fact find tells us that their investments have performed well and the IT has a gain of £65,000. Taking each investment in turn.

- Joint deposit account acts as an emergency fund
- As the rate of interest is low the income will all be within their PSA

- ISA are tax efficient
- They are within the ATR
- The value of the global equity fund is above the FSCS compensation limit
- Mike's Investment Trust has a paper gain of £65,000 which would be subject to CGT on disposal.
- Disposal of the unit trust would incur CGT. The gain would be split 50/50 between Mike and Emma.
- Mike's dividend income is £5,000 so £3,000 would be taxed at 32.5%
- Emma's dividend income is within her dividend allowance.
- The acquisition price of the unit trust would be the total number of units divided by the cost of purchase.
- Tax position could be improved by using their annual ISA exemption
- Switching assets to Emma to mark full use of her dividend allowance, a lower rate and using her CGT exemption.

- All their holdings are equity based with no gilts or bonds
- 56.66% is UK based, 43.34% is non UK.
- Make up of Global Equity fund isn't known
- Exposure to overseas markets exposes them to currency risk
- They could get greater diversification by holding more than one fund in their ISAs

The following questions come from past papers that are fairly similar to this fact find. The names and some of the answers have been amended.

From March 2021 Question 7(B)

identify the key factors that an adviser should consider before recommending the sale of Mike's Investment Trust

- Some of the gain would be charged at 20%
- Availability of CGT exemption
- Any losses to offset
- Transfer to Emma to use her allowance and a lower rate
- Is it trading at a premium or discount to NAV?
- Amount of gearing
- Dividend yield is 3%
- Dividend history
- All UK holdings
- Future prospects

From October 2019 Q4a

Explain in detail to Mike and Emma how they could consolidate their existing investments onto an investment platform and why this might be suitable for them in meeting their long-term objectives

- Can re-register ISAs
- Retains tax efficiency
- Can transfer unit trust in specie
- No market timing risk
- No CGT triggered by transfer
- Could Bed and ISA/pension the unit trust
- Can transfer Investment Trust in specie
- It converts to a nominee arrangement/easier to buy and sell

- Quick transfer process/minimal effort
- Online access/easier to monitor
- Lower cost/large fund discount
- Simplified tax reporting/consolidated reports/access to research
- Wide fund choice
- Improved growth

From the October 2019 paper question 4c

Recommend and justify the actions that Mike and Emma should take in respect of their pensions and investments to increase the prospect of them having sufficient income to retire at age 65.

- Increase pension contributions
- 40% tax relief for Mike/20% for Emma
- Check State Pension BR19
- Use ISA allowance for tax efficiency
- Move IT to Emma as she is a basic rate taxpayer
- Interspousal transfer/no CGT
- She pays tax at 7.5%
- Whereas Mike pays at 32%
- Emma pays CGT at 10%
- Monitor fund performance/ensure appropriate diversification
- Ongoing future reviews

Position on their ISA on death

- The ISAs will have to go through the probate process as ISAs are in single names
- The executors ask the ISA provider to designate it as a **Continuing ISA.**
- This retains its tax privileges whilst it is in the estate.
- This state can remain until the earlier of 3 years from death or the administration of the estate is complete.
- On first death either Mike or Emma will qualify for an **Additional Permitted Subscription**
- This will be the greater of the value of the ISA at date of death or the value when they leave the estate.
- They will have three years from date of death to use this.
- If the provider permits the fund can be transferred in specie.
- This must be done within 180 days of receiving the proceeds.
- Otherwise, a cash subscription must be used by encashing the fund and reinvesting the proceeds into a new ISA.
- This must be one provider but it can be different from the one used by the deceased.
- On second death the executors designate it as a continuing ISA but there would not be an APS as it would not be inherited by a spouse.
- On both first and second death the ISA would be part of the deceased's estate

How best to take the £100,000 needed for the house extension

They have the resources to pay for this but another option would be to borrow by taking out a mortgage on the property

- Loan to valuation is good
- Interest rates currently lower than inflation
- Keep their investments intact and benefit from potential growth
- They have surplus income so repayments are likely to be affordable
- Could qualify for an offset mortgage

- Increases their monthly outgoings
- Repayment over 10 years likely to be expensive
- Costs and fees incurred in setting this up

If they want to use their savings or investments then ideally this should be determined by which one would give them the lowest tax liability.

- Using their existing assets is effectively switching from one asset class to another. As the extension will increase the value of the house their total wealth isn't reduced.
- Encashing the ISA would be tax free but it would mean the ISA allowance had been wiped out
- The unit trusts and the investment trust would create a CGT liability
- But they could each use their own CGT exemption meaning £24,300 could be tax free

Share Incentive Plan

This will probably be an **explain** question.

Mike's employer are looking to offer all features of the scheme:

- **Free shares**. They could offer shares to the value of £3,600 each tax year
- **Partnership shares**. Mike could buy up to £1,800 out of pre tax and NIC income
- **Matching shares**. Mike could receive a further 2 shares for every 1 that he buys
- **Dividend shares** Dividends may be used to purchase further shares within the plan

- Free shares, Partnership shares and matching shares must be held for 5 years to get the full tax benefits.
- If shares are sold within three years, income tax and NIC will be levied on the value of the shares sold

- If shares are sold in years three and four, income tax and NIC are paid on the lower of the market value of the shares at withdrawal AND the salary used to buy the shares (for partnership) or market value on acquisition for matching and free shares
- This is waived if the employee leaves because of redundancy or retirement.

- Disposal is free of CGT as long as the proceeds remain in the plan.
- Alternatively they could take them out of the plan and place into an ISA, subject to them having sufficient ISA allowance

For Mike taking the free shares is a bit of a no brainer as even if they fall in value he would have no financial loss.

- With partnership shares one risk is that if his employer were to go into liquidation he would lose his job but the shares would be worthless
- On the other hand £1,800 a year would be a relatively small amount
- Plus he saves 20% income tax (assume his pension contributions will put him into basic rate tax) plus 12 % NI (and this increases to 13.5% in 22/23)
- Saves £1,800 x 32% = £576 pre 22/23. £603 for 22/23. Plus some could be at 42%/43.25% if he is still in higher rate tax.
- If he takes up the offer it makes sense to take the matching shares

Private Medical Insurance

Most likely question is the factors you would take into consideration on advising whether to keep this going.

- Likely annual rise in premiums
- But Mike's premium cannot be increased because of his deterioration in health.
- Mike's high blood pressure makes it more likely that he may require treatment in the immediate future.
- It also means he would find it difficult to get cover elsewhere
- Scope of existing cover
- Possibility of taking a higher excess
- Possibility of reducing level of cover
- Affordability of premiums

A possible alternative is to cancel the policy but save the £2,800 premium into a personal "health fund" that they could draw on in case he needed treatment. If they never needed this they would still have the money.

Estate planning

- On the current situation they would qualify for £1 million 0% band (NRB + RNRB) on second death (This does not take into account the proceeds of the life policy)
- Pension funds and Emma's inherited SIPP would be outside the estate.
- On current figures they have a liability of £27,600 (£69,000 x 40%)
- However both NRB and RNRB are frozen until 2026
- Therefore the liability will increase as the value of the assets increase.
- By making contributions and/or transferring lump sums into their pensions these are taken outside the estate.
- They should both use their annual exemption.
- Could have investments in AIM shares or invest in EIS
- Provided they are willing they could make lifetime gifts to their children.
- This would reduce their NRB for the next seven years but the full amount would be restored if they survive that long.
- Could consider charitable legacies to get 36% rate

- One option would be to set up a Discretionary Trust
- Initial gift would be a CLT but if below the NRB no immediate tax would be payable
- Like a PET it would reduce the NRB for seven years
- Mike and Emma could be the trustees
- Beneficiaries could be the children and future grandchildren
- As trustees could decide when to pay anyone and who would receive it
- This removes the potential danger if there is marital breakdown or financial difficulties with the children
- Payments can be made to any future grandchildren even though they aren't yet born.
- Could be subject to periodic and exit charges.

- The trust investment should be an Insurance Bond
- As it can be split across different funds it meets the need to have diversification
- No tax liability will arise until there is a chargeable event
- So there is no need to complete an annual tax return.
- If they wish to assign capital they can assign parts of the bond to a beneficiary which is not a CE and therefore no tax on the trustees
- If they wished to provide a regular payment they could use the 5% withdrawal which is not a CE

- Another option would be to put their existing life policy into trust for the benefit of their children.
- This could be appropriate if they don't need the policy now the mortgage is paid off.
- It would provide (until 2027) to pay the IHT is both were to die'
- And would take the proceeds outside the estate

- As the policy has no value it would not be a transfer of value.
- Future premiums would be exempt under the Gifts out of Normal Expenditure rule.

Lasting Power of Attorney

Technical issues

- This can be done whilst they have mental capacity.
- It must be done on the prescribed form
- They could nominate the spouse as their attorney with one of the children as replacement attorney.
- If they appoint both their children they will have to decide whether they should act jointly or jointly and severally
- This means the LPA can continue if either 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) Someone who has known them for at least two years who confirms the donor understands what they are doing.
- It must be registered with the OPG and when this is done it comes into force

If there is no LPA in force and either loses mental capacity, Mike or Emma would have to apply to the Court of Protection to become the other's **deputy**.

- This is more expensive than an LPA
- They will have to take out insurance if they appointed a deputy.
- The COP may not appoint them as deputy
- Their powers will not be as extensive as under an LPA
- If the want to do anything outside the deputyship order they will have to apply to the COP
- They will have to submit an annual report to the COP

Review Question

There are some issues that can usually be included:

- 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