

Report for David & Leanne Adams – Case Study 3

(Report prepared in June 2009 with data for tax year ending 5 April 2010)

1. Objectives

You have advised that your objectives are as follows:

- a) Retirement Planning – you wish to retire at age 55 with a net retirement income of £24,000 pa in today's terms
- b) Providing for your Children – you wish to pay off their university related debts, and pass on to each of them £50,000, subject to limiting access until age 25 or earlier if they need a deposit for a property before then
- c) Investment Planning and Management – how to invest your tax free Premium Bond winnings in a manner that gives you access to most of your cash, with no more than 20% going into equities
- d) Another objective should be Estate Planning – I will give consideration where relevant to this.
- e) A further objective should be simply to have time to adjust to your new circumstances and re-consider what your objectives are without undertaking major commitments with your winnings

2. Retirement Planning

2.1 Assess Target Income

Current expenditure is £32,000 pa, and allowing for income tax and National Insurance Contributions, your income exceeds your outgoings by around £3,000 pa. Your outgoings include mortgage repayments in excess of £6,000 pa and net pension contributions of £1,960 pa. If those were removed your expenditure would indeed be around £24,000 pa so it is a reasonable target.

Assuming Retail Prices Index (RPI) inflation is running at 3% pa, the target of £24,000 becomes £30,400 in broad terms at age 55.

2.2 Projection of Pension Benefits – Existing Accrual

The earliest age at which you can draw your pension benefits is 55. David's pension fund is invested in a Managed fund (i.e. ~ 80% shares; 20% fixed interest & cash) which I have assumed will grow at a net rate of 6.5% per annum. I have also assumed David will remain in employment through to age 55 and that contributions will continue throughout and rise in line with salary at an assumed rate of 5% per annum.

Leanne's pension fund is invested in a UK Equity fund (i.e. ~ 100% shares) which I have assumed will grow at a net rate of 7.0% per annum. I have also assumed Leanne's contributions will continue throughout and remain fixed at £50 pm.

The existing investment choice for your pension funds are not consistent with your cautious attitude to risk. That said, moving from investments mostly exposed to shares into more cautious investments at a time when valuations are low is unattractive. My recommendation is to be pragmatic and maintain your existing investment strategy, however I will want to move to more cautious funds prior to age 55 to reduce the exposure to investment risk prior to annuity purchase.

I have assumed the pension annuities will be on the basis of 50% spouse's benefit with 5 year guarantee, and escalate with RPI at 3%, and that annuity interest rates will be at 4.5%. The annuity rate has been provided by referring to PA90 tables, downrated by 9 years. The annuity rate for David is 3.79%, and for Leanne is 3.56%.

Summarising the outputs from a pension planning spreadsheet:

	Amount for Projection	Projected to 55	Tax Free Cash 25%	RPI Escalating Annuity at 55
David	£67,000 fund plus contributions set at 10% salary	£157,525	£39,381	£4,478
Leanne	£6,000 fund plus contributions set at £50 pm	£16,896	£4,224	£451

Total		£174,420	£43,605	£4,929
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In each case the annuity amounts would be within your personal allowance for income tax so I shall assume these are paid gross from age 55. Subtracting the figure of £4,929 away from £30,400 leaves an income shortfall of £25,471.

2.3 Impact of State Pension Entitlements

You will both be entitled to index-linked state pension benefits from age 65. You can get a forecast of your entitlement to basic state pension and state second pension (also known as state earnings related pension) from The Pension Service online. If you do not have the required history of National Insurance Contributions when you retire at 55, you will want to look closely at making voluntary NICs.

If I assumed your state pension entitlements amounted to say a net sum of £8,000 pa between you in today's terms, at age 55 that would be £10,134, and at 65 it would be £13,619.

Therefore meeting the shortfall in target income from age 55 has two aspects:

- a) part of the shortfall is a substitute for 10 years for the state pension benefits commencing at age 65 (i.e. income of £10,134 rising with RPI to be provided from age 55 to 65). Based on assumed RPI at 3% and assumed interest rates at 4%, you could earmark a capital sum at age 55 of £100,000 to draw down for this.
- b) the balance of the shortfall needs funding as a rising income for the rest of your lives from age 55 (i.e. income of £15,337 rising with RPI). The cost of a purchased life annuity at age 55 on Leanne's life, generating a net income of £15,337 pa, escalating with RPI at 3%, with 50% spouse's benefit for David and 10 year guarantee, would require a purchase premium of £583,600 (using current market leading rate from Standard Life).

The overall cost to be borne at age 55 to meet your target income requirement on this basis would be around £683,600. Part of your Premium Bond winnings can be invested now, earmarked for this. Based on an assumed interest return of 4% pa, a sum of around £500,000 would need earmarking now.

2.4 Age Allowance from 65

It is also worth briefly considering age allowance which arises from age 65 onwards and will increase your personal income tax allowance (from £6,475 to £9,490 on current rates). Age allowance is reduced if a person's taxable income exceeds £22,900 (on current rates), so you will want the majority of investment income in Leanne's name, as David's pension will be higher.

2.5 Projection of Pension Benefits – Maximum Accrual for David

An alternative strategy is to use your Premium Bond winnings to maximum fund David's pension, so that annual premiums were made equivalent to 105% of earnings (based on employer contributions of 5% of earnings and employee contributions of 100% of earnings).

On this basis David's pension fund at age 55 is projected to be £600,600, which would yield a tax free cash sum of £150,150 and a net RPI escalating annuity of around £15,642.

The total cost in 8 years of topping up to maximum employee premiums, net of 20% basic rate income tax relief, is around £250,000. This will lead to an increase in David's pension annuity of £11,164 compared to current accrual.

Furthermore, once the state pension entitlements commence from age 65, the combination of these together with David and Leanne's annuities will meet your target income requirement from 65 onwards.

The income shortfall between age 55 and 65, based on assumed RPI at 3% and assumed interest rates at 4%, could again be met by earmarking a capital sum for drawing down of £100,000, which could be met out of the tax free cash sum.

The cost is around half of that in 2.3, principally because this route benefits from basic rate tax relief on the contributions and the higher assumed investment returns associated with an investment predominantly in shares.

Please note, this option is in conflict with your objectives of keeping your winnings accessible and investing in a cautious manner.

2.6 Comments

Please give consideration to making maximum employee pension contributions of 100% of earnings to David's pension plan up to age 55. Whilst this potentially conflicts with your accessibility and investment risk requirement, the cost benefit deserves close scrutiny.

As you both approach age 55, arrange fund switches from your pension funds over to more cautious funds to reduce the risk associated with your annuity purchase pot.

3. Providing for your Children

3.1 Debt Management

You are each able to make capital gifts of £3,000 pa exempt from inheritance tax, and carry forward an unused gift from last year. I suggest that you make capital gifts within your overall allowance of £12,000, as follows:

- Daniel: £7,000 to cover his student loan of £5,000 and credit card debt of £2,000
- Michael: £4,000 to cover his student loan of £4,000

If Daniel or Michael feel the student loans are not yet worth redeeming (interest on ‘income based loans’ currently 1.5% pa; ‘fixed term loans’ currently 3.8% pa), they can invest in a Cash ISA offering interest at a higher rate, earmarking the capital for the loan repayment at a later date.

The interest charged on credit cards is typically between 15% and 20% pa, so it is important Daniel’s credit card debt is cleared first (watch out for redemption / early repayment penalties).

3.2 Property Ladder

In theory a trust could be used to pass £50,000 each onto the boys, whilst limiting access until age 25, or property purchase. However I am talking about a short period of just a few years so I think it is more sensible and simple to retain control of the capital yourselves and notionally earmark two pots of £50,000.

Each capital gift will be treated as a potentially exempt transfer out of your estate. You will need to survive 7 years thereafter to avoid any potential inheritance tax liability, which is reasonable given your ages and life expectancy.

Finally, one building society is offering family offset accounts. You could deposit £50,000 into an account which would be offset against your son's mortgage. That would allow your son to benefit from the capital with regard to property purchase, but at the same time leave you with control, so that you could defer the decision to pass the capital over your son.

4. Investment Planning & Management

4.1 Debt Management

You have a repayment mortgage with a term ending in 2015, so on the basis that you continue in your employment to age 55, the mortgage will be completely paid off by then. The current fixed rate mortgage deal is at 6% pa and the deal ends 30 June 2009. The outstanding capital is £100,000.

Were you to pay off the mortgage out of your winnings you would effectively benefit from a return net of charges and taxation, in the form of saved interest, of 6% per annum. It is unlikely that a cautious investment could be found that would generate an equivalent net return.

If you wanted the maximum flexibility, to allow you to raise a mortgage again in the future easily, (should you wish to move house later), then an offset mortgage account may be preferable, into which you could deposit £100,000.

Making any such mortgage changes after 30 June 2009 will avoid any redemption penalties on your existing mortgage deal.

That said I recommend maintaining your savings mentality, and that you continue making the monthly 'mortgage payments' into savings.

4.2 Proposed Investment Portfolio

Allowing for the mortgage repayment leaves around £900,000 to be dealt with. I would recommend this is allocated for investment as follows:

	David	Leanne
Cash (high interest deposit)		£40,000
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NS&I Income Bonds		£300,000
NS&I Index Linked Certificates 3yr	£15,000	£15,000
NS&I Index Linked Certificates 5yr	£15,000	£15,000
Gilts		£100,000
Corporate bonds (inv grade)		£85,600
Corporate bonds (inv grade) ISAs	£7,200	£7,200
UK Equities	£50,000	£50,000
Overseas Equities	£30,000	£30,000
NS&I Income Bonds (earmarked for sons)		£100,000
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	£117,200	£782,800

It should be noted that David's salary is not far below the higher rate income tax threshold, so any taxable interest or investment income generated needs to be in Leanne's name.

Any savings accounts held should not exceed the Financial Services Compensation Scheme limit of £50,000 per licensed deposit taker. That said, any investments with National Savings & Investments are 100% guaranteed, which helpfully avoids the need to have a large number of cash deposit accounts of £50,000 each.

The £300,000 in Income Bonds is immediately accessible and could be earmarked for maximum funding David's pension over the years up to age 55.

The NS&I Index Linked Certificates provides tax free returns ahead of inflation, and are accessible if need be.

I recommend investing £200,000 in fixed interest, with corporate bonds put into ISAs this year as the interest will be tax exempt.

In future tax years you will be able to put £10,200 each into an ISA and I recommend investing more of the corporate bonds into ISAs, and thereafter the gilts, and lastly the investments in shares.

The investments in shares can be jointly held to ensure both of your capital gains tax allowances are available to crystallise annual gains in a tax free manner, however any investments in shares held by David should be growth investment so they have little or no dividend income.

The combined investments in gilts, corporate bonds and equities amounts to £280,000 which allows you the choice of using a bespoke stockbroker portfolio as an alternative to using collective investments such as unit trusts, open-ended investment companies or investment trusts.

If you have any social, ethical, environmental or religious considerations you would like to be taken into account, the investments in corporate bonds and equities can be ethically screened to provide a reasonable match to your requirements.

5. Estate Planning (in brief)

Allowing two Inheritance Tax nil rate band allowances totalling £650,000, there would be tax at 40% on estate assets of £579,600, amounting to £231,840.

If David dies whilst in employment, his death in service benefit of £148,000 and pension fund death benefit will inflate your joint estate. David can consult a solicitor to establish a standalone trust to capture these death before retirement benefits (keeping them outside of the taxable estate) and make death benefit nominations in favour of the trust.

You could establish under trust a joint life second death term assurance policy to age 70 for cover of £250,000 that escalated with RPI, to pay the inheritance tax on second death (Aegon Scottish Equitable premium £35.45pm esc RPI). Then by age 65 you should know how much capital you can afford to give away and arrange potentially exempt transfers whilst you still have good life expectancy.

I recommend that you consult a solicitor to establish / review Wills, and discuss the use of a nil rate band discretionary Will trust to protecting against survivor's care costs.

Finally, if you do not have any form of attorney arrangements in place, I recommend that you consult the solicitor about establishing Lasting Powers of Attorney.

6. Reviews & Monitoring

I recommend that your investment portfolio and pension investments are reviewed at least annually.

I recommend that the value of your combined estate and the related inheritance tax liability is monitored at least every 3 years.

I recommend that you review the proposed retirement income target, and the progress of your pension funds and investments towards that, at least every 2 years.

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