

# **Report for Ben & Jane Clark – Case Study 5**

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

## **1. Objectives & Priorities**

You have advised that your objectives are as follows:

- a) Retirement Planning – investigating how to generate a reliable target income of £20,000 pa net in today's terms, and what provision is required for an income for Jane if Ben predeceases her
- b) Investment Planning and Management – how to invest Jane's inheritance and restructure your other savings and investments so that you can meet the objectives set out above, bearing in mind that you wish to have no more than 40% invested in equities. You are keen to retain the real value of your assets over the long term.
- c) Estate Planning – minimise the inheritance tax payable on the death of Ben and Jane.
- d) 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 inheritance.

For the purpose of this report I will focus primarily on Retirement Planning, Investment Planning & Management and Estate Planning.

## **2. Retirement Planning**

### **2.1 Income & Expenditure**

The target income is £20,000 pa net in today's terms to meet your expenditure.

Ignoring Jane's inheritance of £247,000 at this stage, there is a deficit of income versus expenditure. Income arising from Ben's annuity and savings interest amounts to around £16,475 after income tax. With expenditure at around £20,000, there is a deficit in income of around £3,525 per annum, so the current low interest rates have been causing you to eat into capital.

Given that Jane is a non-taxpayer, the Abbey National account should be in her name only so that she can earn the gross interest, tax free.

### **2.2 State Pension Entitlement**

It should be noted that when Ben attains age 65 he will be entitled to receive state pension benefits which are linked to RPI and will be a useful contribution to your ongoing income requirements, and you can get a forecast of Ben's state pension entitlement (which may also include state earnings related pension / state second pension) from The Pension Service online (or by using a BR19 form). If Ben does not have the required history of National Insurance Contributions because he retired at 56, you will want to look closely at the option of making voluntary NICs if it is available.

Whilst Jane has not worked during her lifetime, she may have an entitlement to state pension, either through previously making voluntary NICs or through the spouse's state pension. Assuming Jane was born in 1951 her state pension age will be around age 61 (subject to a sliding scale for women born between 6 April 1950 and 5 April 1955) so a pension arising from voluntary NICs would commence then. A pension arising from the spouse's state pension would commence when Ben is 65. Again it would be worth getting a forecast of Jane's state pension entitlement from The Pension Service online (or by using a BR19 form), and establishing if there is any benefit associated with making voluntary NICs.

### **2.3 Age Allowance**

In addition to the above, at age 65 Ben will become entitled to an enhanced personal income tax allowance, increasing his personal allowance from £6,475 to £9,490. This is subject to a requirement that Ben's overall taxable income does not exceed the age allowance limit, currently set at £22,900. This reduced taxation would increase Ben's net income by £603 pa based on current rates.

### **2.4 Income Planning**

In all likelihood the bulk of the current income deficit of £3,525 will therefore be made up by the commencement of state pensions in 3-4 years time and the introduction of an enhanced personal allowance.

The current need therefore is to top-up your existing income by £3,525 net per annum in today's terms, until the state pensions and the enhanced personal allowance commence. Assuming RPI inflation is running at 3% pa and deposit interest of 4% pa, a capital sum of £14,000 set aside in a deposit account to be drawn down over the 4 years should suffice.

Thereafter, it is doubtful that there will be a need to top-up your income at all or if so, it will only be by a very small amount.

## 2.5 Ben Predeceasing Jane

In the event of Ben predeceasing Jane, Ben's single life annuity will cease. Whilst Jane's expenditure requirement may not then be £20,000 pa net in today's terms, she will need to raise most of the money herself to replace Ben's annuity.

### 2.5a) Purchased Life Annuity

The best way to generate a reliable income in this respect is to use a purchased life annuity, which has the added benefit of having much of its payment treated as a return of capital, and hence exempt from income tax, which helps to ensure Jane's gross taxable income can stay below the age allowance threshold.

Ben's gross annuity of £18,000 pa equates to a net income of £15,695 pa.

Let us assume Jane only needs to generate 2/3<sup>rd</sup> of that amount, say net income of £10,463. To generate such a net income, a purchased life annuity for Jane escalating with RPI at 3%, at today's rates, would require a purchase premium of around £316,200. If Ben were to die in the near future, you would have just enough liquid assets to buy a purchased life annuity, but it would leave you with very little by way of remaining liquid assets as emergency funds etc

As time passes and Jane's life expectancy decreases, she will get a higher level of income from a purchased life annuity and at some stage in the next 20 years a purchased life annuity may become a much more affordable option.

Whilst this route will provide a reliable income, it does conflict with your objective of retaining the real value of your assets over the long term as ultimately, the income will die with Jane.

### 2.5b) Cautiously Managed Portfolio

An alternative to the above is to establish a cautiously managed investment portfolio comprising a mixture of equities and fixed interest stock, with the primary objective of generating a rising income.

If I use an assumed net income yield for such a portfolio of around 4% per annum, to generate an income of £10,463 the portfolio value would need to be around £261,575 (which is more affordable than 2.5a) by £55,000 and also allows you ongoing control of and access to the capital).

### **3. Investment Planning & Management**

#### **3.1 Immediate Income Needs**

Referring to 2.4 above, the current need is to top-up your existing income by £3,525 net per annum in today's terms, until the state pensions and the enhanced personal allowance commence. A capital sum of £14,000 could be set aside in a deposit account to be drawn down over the 4 years to Ben's 65<sup>th</sup> birthday.

Alternatively you could establish an investment portfolio with a view to drawing a net income yield of £3,525, rising with RPI, which you would cease to draw from age 65 onwards. Indeed once Ben attains age 65 the portfolio objective is capital growth ahead of inflation, so any residual income could then be re-invested to help with accumulation.

#### **3.2 Existing Investments**

Ben invested £9,150 into the Artemis Global Growth fund in March 2004. The value of the investment on 30 June 2009 (based on a unit price of 74.6p) was £11,190, reflecting a capital gain of £2,040. This is well within Ben's annual capital gains tax allowance of £10,100 so if this holding were sold there would be no liability to capital gains tax (charged at 18%).

#### **3.3 Income Tax**

It should be noted that Jane has a substantial amount of unused personal income tax allowance. The personal allowance is presently £6,475 and there is currently £6,117 unused. Therefore all savings and investments generating a taxable income must be in Jane's name to make the most of her personal allowance.

Secondly when Ben attains age 65 he will become entitled to an enhanced personal allowance as we discussed earlier. The state pension when added to Ben's annuity will take him rather close to the age allowance limit, so this is another compelling reason why all savings and investments generating a taxable income must be in Jane's name.

#### **3.4 Proposed Investment Portfolio**

Your existing liquid assets plus Jane's inheritance total £340,190, I would propose this is invested as follows:

	Ben	Jane	Estimated Yield
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Cash		£23,190	2.0%
Cash ISA	£7,000		3.0%
NS&I IL Certs 3yr	£15,000	£15,000	RPI + 1.0%
NS&I IL Certs 5yr	£10,000	£10,000	RPI + 1.0%
Index Linked Gilts		£50,000	RPI + 1.0%
Gilts		£50,000	4.0%
Corporate bonds (inv grade)		£39,600	5.0%
Corporate bonds (inv grade) ISAs	£10,200	£10,200	5.0%
UK Equities		£75,000	4.0%
Overseas Equities		£25,000	2.0%
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	£42,200	£297,990	

The combined investments in index-linked gilts, gilts, corporate bonds and equities amounts to £260,000 with an overall assumed net yield of 4% pa. The portfolio is large enough to allow 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 there is a desire to use Ben's annual capital gains tax allowance, some investments in shares can be transferred across to him prior to disposal.

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

I recommend investing £160,000 in fixed interest, with corporate bonds put into ISAs this year as the interest will be tax exempt. If the ISA investments are made in October 2009 the new higher ISA limits of £10,200 each will apply.

In future tax years I recommend investing more of the corporate bonds into ISAs, and thereafter the gilts, index-linked gilts and lastly the investments in shares.

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.

### 3.5 Income Funds

Income funds generally refer to investments in fixed interest securities, particularly gilts and corporate bonds. Occasionally they also refer to 'equity income' funds which focus on shares with strong dividend yields.

#### 3.5a) Corporate Bond Funds

Some funds investing in corporate bonds have been offering yields of around 6% per annum. Corporate bonds are loans to companies so the interest payable is dependent upon the financial strength (i.e. credit worthiness) of the company concerned, and the combination of the credit crunch and the recession have brought the financial strength of many previously regarded quality holdings into question.

High yields are available where the bond holdings have lower credit ratings.

I recommend you only invest in 'investment grade' fixed interest, which is usually regarded as corporate bonds with credit ratings AAA – BBB.

Furthermore, such loans can take the form of 'senior debt', or 'subordinated debt'. In the event of insolvency, holders of 'senior debt' get paid out first ahead of holders of 'subordinated debt'. Where possible I would recommend a focus on 'senior debt'.

An investment grade bond fund focusing on senior debt is unlikely to offer returns as high as 6% pa, indeed the expectation is around 5% pa, however your capital will be at much less risk.

### 3.5b) Equity Income Funds

With shares continuing at depressed values and dividends for a number of companies staying at reasonably high levels, the dividend yields (the annual dividend income from one share as a percentage of the value of one share) for a number of shares are between 4% and 8%.

In my view this is a temporary circumstance which will only last for as long as share prices remain depressed, thereafter they will revert to between 3% and 4%.

#### **4. Estate Planning**

Your Wills leave everything to each other, and then on the second death to James.

Your combined net worth, including Jane's inheritance, amounts to £644,000.

Allowing for the use of two Inheritance Tax nil rate band allowances currently amounting to £650,000 in total, there would be no excess of estate assets that would attract inheritance tax at 40%. Current rules allow for the nil rate band on the death of the first spouse to be carried forward and added to the nil rate applying on the death of the second spouse.

So as things stand there would be no Inheritance Tax arising on second death.

You may wish to review your Wills with your solicitor and discuss the use of a nil rate band discretionary trust in the Wills to be used on first death as a means to protect against the estate being diminished by care costs associated with the survivor.

Alternatively, if it is likely that James will remain in the family home, you could look at passing a share in the house to him. James is already an occupier so he would become an owner occupier.

Finally, if you do not have any form of attorney arrangements in place, I recommend that you consult your solicitor about establishing Lasting Powers of Attorney. It is a cost of a few hundred pounds now, but in the event of incapacity, it will save thousands of pounds in costs and very many hours of time associated with dealing with the Court of Protection.

## **5. Reviews & Monitoring**

I recommend that your income requirements and your investment portfolio 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.

In the event of Ben's death, I recommend that we look very closely at the options available to Jane.

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