PRUDENTIAL

The Peter Piper Case Study

Considering clients' holistic financial needs to uncover client-centric solutions

Contents

Meet Peter Piper

Peter, 51, is recently divorced. He has his own engineering company, Piper Ltd, which he built up from scratch after leaving Shell eight years ago.

Piper Ltd employs 20 people and has an annual turnover of approximately £600,000 from which it consistently generates a profit of £100,000. Peter draws £50,000 salary and £10,000 dividends, although he is not sure if this is the best way to operate. The company currently has £450,000 in cash sitting on the balance sheet. £300,000 of this has been identified as being surplus to future business requirements and has therefore been deposited in a business 'saver' account earning 1.0% gross. Piper Ltd has an overall balance sheet total of £1m.

- Peter has a 12-year-old daughter, who attends school and lives with his ex-wife.
- Having always had a strong savings ethic, Peter has been saving into an ISA on a regular basis.
- His home is unencumbered and valued at £270,000.
- His only pension arrangement is a deferred final salary pension with his previous employer Shell, which is due to pay a pension of £38,000 per annum at age 60. Peter was surprised that his recent transfer value appraised his scheme at £750,000. He planned to retire at age 57 but was disappointed to find his scheme has an 8% reduction in his pension for each year he retires early. He currently makes no pension contributions.
- As the only beneficiary of his mother's will, Peter inherited OEICs and his mother's property 12 months ago.

Peter's assets

Personal residence	£270,000
Stocks and shares ISAs	£70,000
OEICs (probate value was £22,000)	£30,000
Cash from sale of late mother's property	£170,000
Cash	£5,000
Personal effects	£20,000
Pensions CETV	£750,000
Final salary pension at age 60 (pre commutation)	£38,000
Estimated value of business	£1,500,000

Peter's aims and advice needs

Peter has a range of planning needs as detailed below:

- Peter wants advice on the most cost-effective way to manage the company profits and his income.
- He needs advice regarding the £300,000 surplus cash held by Piper Ltd.
- Peter would like to retire at age 57 and, to make a clean break from the engineering industry, selling his shares in Piper Ltd. He is concerned about the early retirement factor and has been told he should consider transferring his scheme to a personal pension, which would give him the option of taking his money as and when he requires.
- He is also concerned about his potential Capital Gains Tax bill when he sells his business and has heard of something called Entrepreneurs' Relief.
- He would like to fund his daughter's university costs, as he wants her to start her working career free of debt.
- He is concerned about his potential Inheritance Tax (IHT) liability, which has been exacerbated following his recent inheritance. He has carried out no IHT planning in the past but would like to pass on some wealth to his daughter in the future. He realises she is too young at this time.
- Peter says he is not a risk taker, keeps very good health and hopes to live at least as long as his mother. She passed away at age 93 and longevity generally runs in Peter's family.
- Peter lives and works in England, so the **Scottish Rate of Income Tax (SRIT)**, does not apply.

Current tax position 2017/18

Income Tax and National Insurance (NI) liability

£50,000 salary and £10,000 dividends

› £11,500 @ 0%	= £0
› £33,500 @ 20%	= £6,700
› £5,000 @ 40%	= £2,000
› £5,000 dividends @ 0%	= £0
› £5,000 dividends @ 32.5%	= £1,625
› **Total Income Tax**	**= £10,325**
› NI (employee) £8,164 @ 0%	= £0
› NI (employee) £36,868 @ 12%	= £4,424
› NI (employee) £4,968 @ 2%	= £99
› **Total National Insurance contributions (NIC)**	**= £4,523**
› **Total tax and NIC**	**= £14,848**
› **Net income**	**= £45,152**
› NI (employer) = £8,164 @ 0%	= £0
› NI (employer) = £41,836 @ 13.8%	= £5,773

Capital Gains Tax liability

No disposals.

IHT liability

Total Assets	£2,065,000	**Total Reliefs (?) ***	£1,500,000
Net Estate	£65,000	**Tax @ 40%**	£26,000

* We discuss the total reliefs later in this case study.

Pension allowances

Annual allowance

Year	Used	Unused	Available in 2017/18	Available in 2018/19
2014/15	£0	£40,000	£40,000	£0
2015/16	£0	£40,000	£40,000	£40,000
2016/17	£0	£40,000	£40,000	£40,000
2017/18	£0	£40,000	£40,000	£40,000

Lifetime allowance (LTA)

- Defined benefit pension at normal retirement date (NRD) (2026/27) £38,000 x 20 = £760,000
- Projected LTA to 2026/27 (Consumer Prices Index (CPI) @ 2.5%) = £1,248,863
- LTA headroom = £488,863

Scenario 1: Planning for early retirement

Peter would like to retire at age 57. He is concerned about the early retirement factor and has been told he should consider transferring his scheme to a personal pension, which would give him the option of taking his money as and when he requires. He needs advice on whether to transfer to defined contribution (DC) or maintain the defined benefit (DB) pension.

Key information

› Normal Retirement Date	60
› Projected pension at normal retirement date (NRD)	£38,000
› Early Retirement Factor	8%
› Cash equivalent transfer value (CETV)	£750,000

With pensions being the most valuable assets held by many clients it's important that the clients' advisers ensure that they receive appropriate specialist advice in this area. Decisions need to be carefully considered as they can have a permanent impact on a client's lifestyle. In Peter's case, the debate is between retaining his current DB scheme and the option of transferring to a DC scheme. Although this is an age-old discussion, it's been given a twist with the pension freedom legislation that came into force on 6 April 2015.

In many cases it may not be appropriate to transfer from a DB scheme to DC, as the safeguarded benefits available in a DB scheme may be difficult to replicate within a personal pension. While the investment risk in a DB scheme sits with the employer, in a DC scheme this sits with the individual member. However, there are some circumstances where it may be advantageous. These include:

- **£ incentive:** the employer may offer an incentive to move from the DB scheme. This may be in the form of an enhanced transfer value or occasionally a lump sum. The employer may seek to do this to reduce the liabilities of the business. However, even considering this enhancement it is still often not appropriate to transfer.
- **Withdrawal flexibility:** a DB scheme does not offer the same flexible withdrawal options as available in a DC scheme. DB schemes can only pay a scheme pension, whereas, DC has the options of capped drawdown (where an arrangement is in place prior to April 2015), flexi-access drawdown, or uncrystallised funds pension lump sum. What's more, if the client needs access to tax-free cash, but not an annual income, then a DB scheme will not offer this flexibility.
- **Retirement age flexibility:** for example, the DB scheme may have a retirement age of 65, and the client wishes to retire at age 60. Penalties in the form of actuarial reductions for early retirement can be quite high in some DB schemes.
- **Value of additional benefits:** there may be benefits available under the DB scheme which are not required, for example, dependant's benefits where the member may no longer have any dependants, or spouse's pension when the member is not married. The value of these benefits would be reflected in the transfer value. As such, there may be potential for a higher income via an annuity (reflecting the client's needs), or through a flexi-access drawdown contract.

- **Higher income potential:** the client may have shortened life expectancy so an impaired life or enhanced annuity, which takes into account the individual's personal circumstances, may provide a higher level of income. DB scheme pensions don't take the individual's life expectancy into account.
- **Avoiding the PPF:** the DB scheme may be in danger of entering the Pension Protection Fund (PPF) and the protected amount under the PPF may be lower than the expected level of benefits. However, consideration should be given as to whether or not the benefits in the PPF would be enough for the client, if this is the only driver for transfer.

Assessing a transfer

The first step in assessing a transfer is to request a "Statement of Entitlement" from the Scheme Administrators. The member can usually request one of these every 12 months free of charge. The Statement of Entitlement will provide details of the current benefits payable and the transfer value. A Pension Transfer Specialist is required to help the client analyse this information in light of the client's personal needs and financial circumstances. The adviser must carefully document this process and help the client consider the:

- costs of moving
- transference of risk from the scheme onto themselves
- potential benefits lost by moving
- required critical yield.

Only then, can they advise the client whether a transfer from the scheme is advisable.

Critical yield

The critical yield is the estimated investment return, after charges, that must be achieved in order for the transfer value to match the benefits currently offered by the DB scheme. The calculation is normally done using a defined set of assumptions using a Transfer Value Analysis System, or TVAS.

TVAS

This is an automated system, which calculates the investment return required from a personal pension fund to provide the same benefits as those given up by transferring. The system is dependent on demographic and economic assumptions. These are detailed in the FCA's Conduct of Business Sourcebook (COBS).

TVAS assumptions

Certain assumptions are required to be able to calculate the critical yield. Currently they are:

- annuity interest rates – these are set by the FCA and is the way in which future pension payments are valued;
- revaluation rates – this currently set as RPI and AEI (Average Earnings Index);
- indexation/escalation rates for RPI-linked benefits;
- indexation/escalation rates for CPI-linked benefits; and
- mortality – Institute and Faculty of Actuaries' Continuous Mortality Investigation tables PCMA08 and PCFA08.

See **COBS 19.1 Pension transfers, conversions and opt-outs.**

These assumptions may change from time to time – see section below on the FCA's consultation paper CP12/4 and policy statement PS12/8. There are also changes being consulted on under CP17/16. A change in the assumptions can have a major impact on the critical yield required. More cautious assumptions can also be used.

For example, an increase in the annuity interest rate would mean that the amount of capital needed to provide the same annuity would decrease and the critical yield would decrease. If mortality assumptions change, for example, to accommodate the fact that people are living longer, then the critical yield would increase.

A key point is that meeting the critical yield does not guarantee matching benefits. For benefits to match, all assumptions would need to be met exactly, which is unlikely.

The critical yield could be exceeded and benefits not matched if the other assumptions are not met. Conversely, the yield may not be achieved but benefits matched due to a compensating change in other assumptions.

The assumptions are by their nature subjective and likely to change as they include matters such as expected inflation and changes in average earnings.

Although transfer values (Cash Equivalent Transfer Values, or CETV) are issued with a "guaranteed to" date there are occasions when the value may change prior to this date. In these circumstances, it is important to have the TVAS completed again to ensure it is up to date. One reason for a change in CETV is that the member may have secured some or all of the benefits thereby reducing the liability. Where this happens the cash equivalent is reduced (perhaps to nil if all benefits have been taken).

Calculation of the Cash Equivalent Transfer Value (CETV)

For DB schemes, the calculation of the cash transfer sum is set out in The Occupational Pension Schemes (Transfer Values) Regulations 1996.

These regulations were amended by the Occupational Pension Schemes (Transfer Values) (Amendment) Regulations 2008 and some substantial changes were introduced in the way that the transfer values were calculated. The initial cash equivalent must be calculated on an actuarial basis and this must take into account accrued benefits, any options and any discretionary benefits. The trustees, acting on actuarial assumptions, must, in relation to salary-related benefits, consider the financial, economic and demographic assumptions on which the initial cash equivalent is calculated. A minimum level is stated in the regulations but trustees can pay out higher than the minimum level if the scheme rules allow this.

Deductions can then be made. The transfer regulations should mean that there is not much variation in transfer values. However, there is still scope within the regulations to allow a variation, which could mean that there is a range of different transfer values for the same set of benefits. The four main reasons for variation are:

- **assumed discounting rate** – this is the interest rate used to discount future benefits into current money;
- **pension increases** – it may be fairly simple to calculate statutory or guaranteed increases but there may be discretionary increases which have to be factored in;
- **underfunding** – a "scheme insufficiency report" has to be prepared by an actuary; and
- **reinstatement**.

Reasonable administrative costs may also be deducted. The amount can also be reduced because of a criminal, negligent or fraudulent act or omission. The sum left is the CETV.

The 2008 regulations also place added disclosure obligations upon the trustees. The trustees must provide the CETV within three months of request and then the member has three months (from a "guarantee date") in which to accept the transfer value. If the member does not accept within the three-month period then the amount is not guaranteed. If the member accepts the amount, a written application must be made to the trustees and this must be paid within six months of the guarantee date.

See **The Occupational Pension Schemes (Transfer Values) Regulations 1996 (as amended)**.

Further considerations for how this impacts on Peter

Appetite for risk: Peter is a cautious investor – while the pension rights are retained within the DB scheme the investment risk remains with the employer. If he were to transfer this scheme to a DC scheme, he would carry the investment risk.

Valuation vs benefits: although the value of £750,000 may sound a fair sum in comparison with the £38,000 pension at age 60, as the DB scheme will provide additional benefits (such as an inflation-proofed pension) the CETV may not be as generous as it first appears. If this were an annuity the initial rate would be 5.07% for an increasing annuity, which could be viewed as generous in the current environment.

Let's assume:

1. A 5% pa growth rate
2. Inflation post retirement at 3%
3. An initial adviser charge of 1% to advise on and facilitate the transfer
4. A 0.5% per annum ongoing charge to provide regular reviews
5. An annual management charge of 1.35%

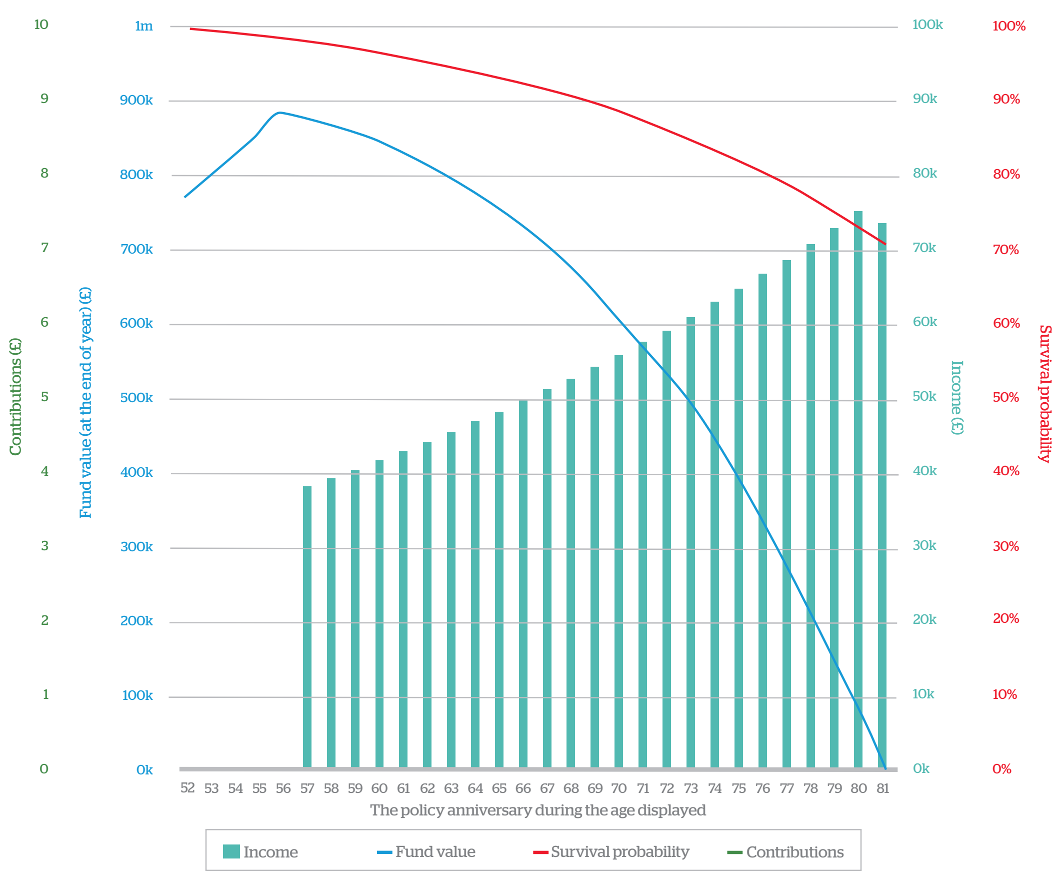
As the following chart shows, if Peter transferred to a DC arrangement the pension fund would deplete over time. Based on our various assumptions, the fund would only last until Peter was age 81, when he still has a 70% probability of being alive. Assuming Peter lived longer than age 81 the income from his pension would stop with resultant impact on his standard of living (it's important to remember that longevity runs in Peter's family). Investment performance seldom provides a constant return, even a couple of poor performing years can have a dramatic effect on the final outcome (pound cost ravaging).

In addition, there would be other benefits attached to the DB scheme, such as spouse's pensions etc. which although not relevant at this stage of Peter's life may become so in the future.

Death benefits: a comparison of the death benefits provided by the DB scheme would be part of a comprehensive transfer review.

It is likely that transferring the pension would create a larger lump sum death benefit than retaining the DB scheme. This is because the DC scheme would provide "return of fund" on Peter's death, as opposed to the DB scheme which is likely to focus more on dependants' benefits.

In the event of Peter's untimely demise, the DB scheme is likely to provide his daughter with an income while she is in full-time education, or if Peter has no dependants at the time of death it will provide a multiple of Peter's pension benefits as a lump sum death benefit.



DB schemes usually provide spouse's pension and/or dependant children's pensions at 50% of member's benefits (members benefits may be regarded as current pension benefits, or anticipated pension had the member survived to scheme NRD, or somewhere in between) although this can vary from scheme to scheme.

Peter may consider that the current DB scheme death benefits, together with his other assets, provide his daughter with a sufficient inheritance and as such increased death benefits may not be a priority.

Early retirement penalty: another argument that may be offered to support transfer of the pension is the early retirement penalty of 8% per annum that is attached to the DB scheme, given that Peter wants to retire at age 57 and the scheme NRD is age 60. Assuming Peter stays in his DB pension scheme taking his pension at age 57, this would result in a 24% reduction in his starting pension, reducing his pension from the anticipated £38,000 to nearer to £28,880, with the ongoing – as well as immediate – impact on his standard of living.

Peter's options

Option 1 – Insure the death benefits

A major current transfer driver from DB schemes is the provision of death benefits. The scheme benefits may appear unattractive on death, especially if you have no dependants. So the ability to direct what is left from your DC pot (post transfer) is often a valid concern.

But wouldn't insuring the death benefits give you the best of both worlds?

You can retain the guaranteed income from the scheme, without taking on the associated risks of self-insuring your income (and the fund that you want to pass on). Peter's income at present is sufficient to meet his needs, but analysing his expenditure (both now and in his retirement) may identify that there is an excess of income that could be used.

If Peter has excess income this could be used to enact a Whole of Life (WOL) plan (written in trust to avoid IHT) to provide death benefits equivalent to the CETV.

If the WOL (in trust) plan is funded using the normal expenditure out of income exemption then there will be no IHT implications should Peter die. If the WOL plan is on guaranteed rates, then there is no investment risk from an underlying fund. This could also have the added benefit that if the cover were level then this may provide more of a death benefit as there will be no fund depletion to provide an income. Additionally for a guaranteed plan, if the cover is level then the premiums will also be level, which should make this more affordable when his increasing DB income commences.

To use the normal expenditure out of income exemption three conditions must be met. It:

1. formed part of the transferor's normal expenditure,
2. was made out of income (taking one year with another), and
3. left the transferor with enough income to maintain his/her normal standard of living.

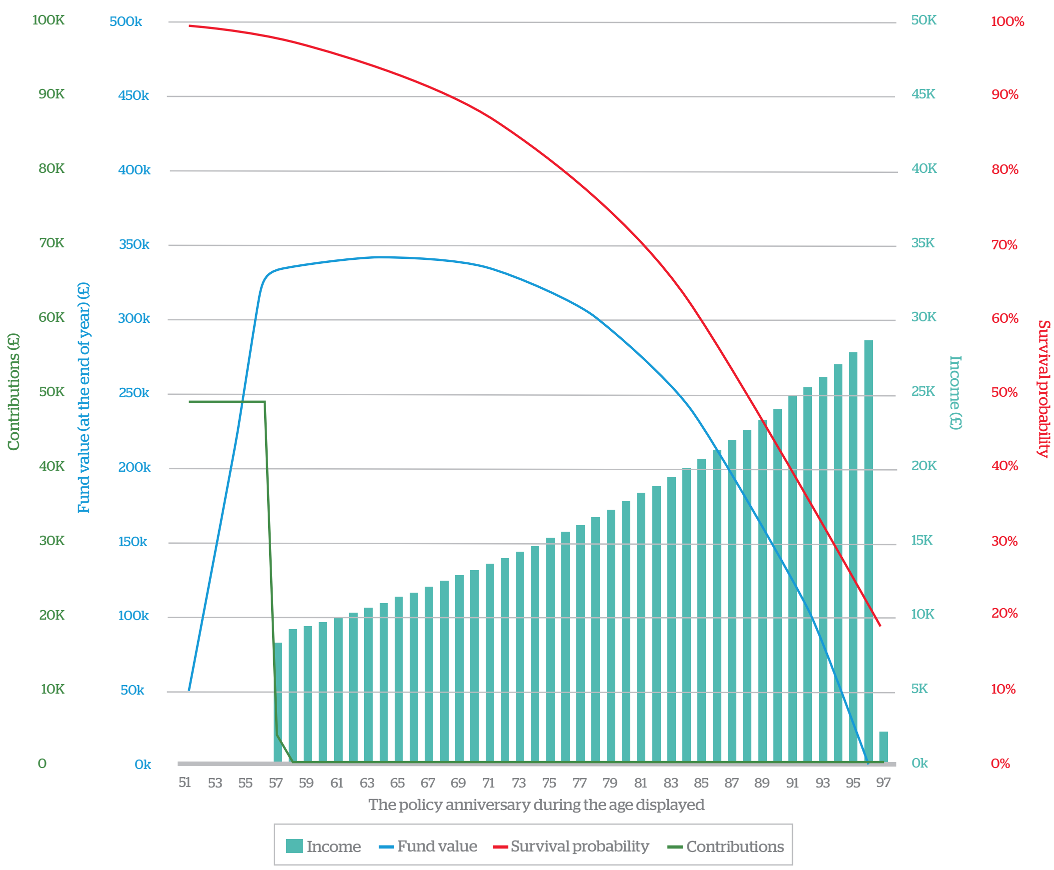
Even if Peter cannot use the normal expenditure out of income exemption, then he could potentially use his annual exemption for IHT. An individual's lifetime transfers are exempt up to a total of £3,000 in each tax year. So a WOL level monthly premium of £250 would be covered under this exemption.

By taking this course of action Peter does not have to take on the risks associated with the DB transfer. He will also have a WOL plan that can provide a sizable (and as detailed above potentially IHT free) lump sum to match what could have been achieved from a DB transfer. A win/win solution?

The acceptance of the contract by the insurer would of course be subject to underwriting. Peter could be accepted at normal rates, based on his good health. For other clients with poorer health, this may not be an option, but is certainly one worth exploring.

Option 2 – Retire at age 57 and take the DB scheme at age 57 and bridge the gap caused by early retirement

Peter could fund pension contributions to establish a pension capable of providing an additional income of £9,120 per annum, bridging the gap between the £28,880 from his DB scheme at age 57 and the required £38,000 per annum. Based on providing this additional income for, say, 40 years and based on the same assumptions as previously used, this requires an annual gross contribution of £49,084 for the next six years. Although this level of contribution exceeds the Annual Allowance, Peter could use carry forward allowances for some of the contributions.



Option 3 – Retire at age 57, defer the DB scheme to age 60 and bridge the three-year gap in income

This option allows Peter to defer drawing his DB scheme until the scheme's normal retirement age (60) and bridge the income gap between the age he wants to retire at and the scheme's NRD, in a very cost-effective manner.

Pension flexibility now allows Peter to build a pension fund to furnish his income requirement between age 57 and 60 exclusively. A pension contribution of £16,365 gross per annum over the six years to age 57 would be required to fund the £38,000 required income for the three years between age 57 and age 60, at which point the full £38,000 from the DB scheme would commence (using the same assumptions as before). The most efficient methods of funding this pension contribution are discussed later in this case study.

Case study

Client age (at start of year)	Used Fund Value (at end of year)	Income
51	£16,915	£0
52	£34,376	£0
53	£52,419	£0
54	£71,100	£0
55	£90,403	£0
56	£110,381	£0
57	£74,793	£38,000
58	£37,982	£38,000
59	£0	£37,982

Peter has sufficient Lifetime Allowance (LTA) headroom to allow the funding of this additional pension without creating an LTA charge issue.

Prudential's Retirement Modeller facilitates the ability to work through multiple scenarios using basic and complex inputs.

Potential courses of action

- ☒ Do not transfer the DB pension at this time
- ☑ Look to provide Whole of Life cover
- ☑ Review transfer decision annually
- ☑ Begin additional pension funding

Scenario 2: Extracting company profits

Peter wants advice on the most cost-effective way to manage the company profits and his income.

Income Tax and National Insurance (NI) liability 2017/18

£50,000 salary and £10,000 dividends	
£11,500 @ 0%	£0
£33,500 @ 20%	£6,700
£5,000 @ 40%	£2,000
£5,000 dividends @ 0%	£0
£5,000 dividends @ 32.5%	£1,625
Income Tax	£10,325
National Insurance (Employee)	£4,523
Tax and NI	£14,848
Net income	£45,152
National Insurance (Employer)	£5,773

The company currently has £450,000 in cash sitting on the balance sheet. £300,000 of this has been identified as being surplus to future business requirements.

Peter's options

Option 1 – Changing the shape of remuneration

As the employee, director and shareholder of his company, Peter has a degree of autonomy in the shape of his income that is not usually afforded to employees. It could be argued that his current remuneration methodology is not the most efficient and less weighting towards salary and greater weighting towards dividends would produce a more effective result. In the tax year 2017/18 a salary between the Lower Earnings Limit and the Primary Threshold would result in no primary or secondary NI contributions being paid, but NI contributions would be credited, ensuring State Pension entitlement is maintained. It is important to remember that Peter will be unlikely to qualify for the full state pension (flat rate) as he will have been contracted out within the DB scheme. A state pension forecast, "BR19", should be requested.

In the past, when lenders used multiples of salary in calculating a client's potential mortgage amount, a lower salary could have created an issue. However, with mortgage lenders' emphasis now firmly on affordability, lenders are prepared to take into account dividends (with supportable evidence) as part of overall income.

In addition, the greater autonomy allows Peter to make employer contributions to his pension. Employer pension contributions are classed as a business expense (as long as they are wholly and exclusively), they're not liable to employers' National Insurance contributions, nor are they taxable on the employee as a "benefit in kind". With salary sacrifice models, the employer may choose to include the savings in secondary National Insurance contributions as additional pension contributions. However, it's important to note that any salary sacrificed after the 8 July 2015 budget will count towards the calculation of "Threshold Income" for the reduction in Annual Allowance for higher earners.

Income Tax and National Insurance (NI) liability

£50,000 salary and £10,000 dividends

› £11,500 @ 0%	= £0
› £33,500 @ 20%	= £6,700
› £5,000 @ 40%	= £2,000
› £5,000 dividends @ 0%	= £0
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› **Net income**	**= £45,152**
› NI (employer) = £8,164 @ 0%	= £0
› NI (employer) = £41,836 @ 13.8%	= £5,773

Alternative method (using a bit of reverse engineering) £8,164 salary and £40,227 net dividends

› £8,164 @ 0%	= £0
› £3,336 dividends @ 0% (personal allowance)	= £0
› £5,000 dividends @ 0%	= £0
› £28,500 dividends @ 7.5%	= £2,137
› £3,391 dividends @ 32.5%	= £1,102
› **Total Income Tax**	**= £3,239**
› National Insurance (primary)	= £Nil
› **Net income**	**= £45,152**
› NI (employer)	= £Nil

So, in the 2017/2018 tax year changing the shape of the income from salary to dividends saves the company £8,336. This could be used to provide an employer pension contribution at no cost to the employee or the company. As the pension contribution should obtain Corporation Tax relief under the "wholly and exclusively" rules this would mean that the company can pay a pension contribution of £10,292 at no extra cost.

Cost to company
£50,000 salary + £10,000 dividends + £2,346 Corporation Tax on dividends + £5,773 NIC = £68,119
£8,164 salary + £40,227 dividends + £9,436 Corporation Tax on dividends = £57,827
Saving £10,292

Therefore, the benefit of amending the shape of his income to produce an employer's pension contribution is undeniable. Peter's company costs are the same, his net income is the same and he has the funds for pension planning.

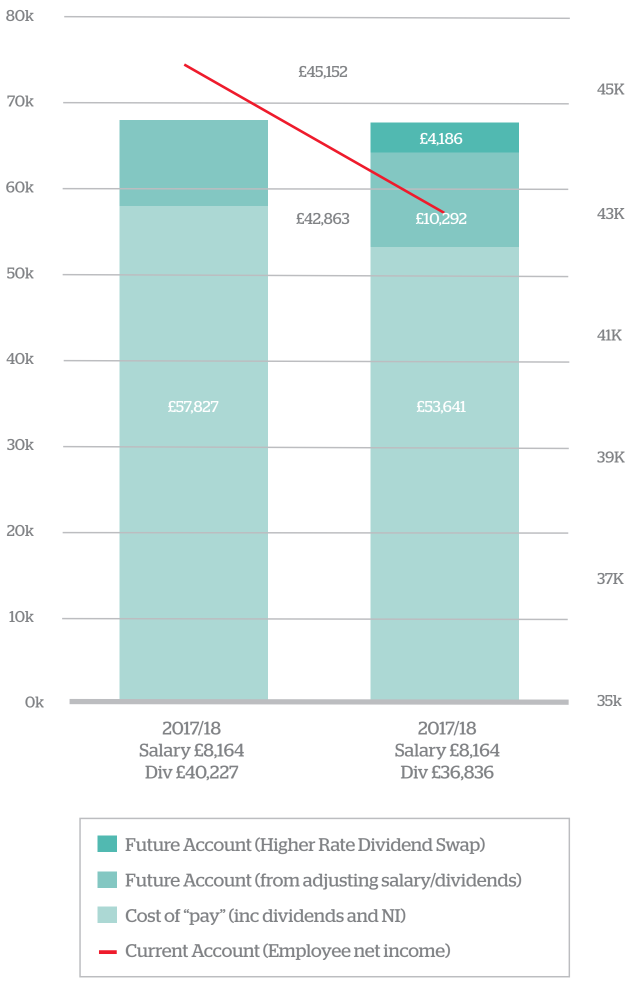
Option 2 – Higher rate dividend swap

Changing the shape of Peter's income has achieved a significant saving to the company, which can thereafter be used as an employer's pension contribution for Peter's benefit. There are still tax inefficiencies within Peter's revised remuneration. Although changing the shape of Peter's income has reduced the tax and NIC payable, there is still a portion of Peter's income that remains within the higher rate tax band. This will be true of many small business owners.

By "sacrificing" the portion of the dividend that falls into the higher rate tax band, this would allow an employer pension contribution to the value of the gross cost of the dividend. In Peter's case he has £3,391 of his dividend within the higher rate tax band. If he sacrifices this portion of his dividend, it will reduce his net income by £2,289 (£3,391 dividend less the £1,102 dividend tax which would have been payable on this dividend). However this would allow the company to pay a company contribution of £4,186 (gross cost to the company of the £3,391 dividend) to Peter's pension. Peter is effectively giving up £2,289 in his current account today, to make a £4,186 into his "future account", so that he will be able to boost his current account in the future.

Obviously the benefit of this action will depend on Peter's tax position when he draws from his "future account". Ignoring any potential investment return, if Peter is a non-taxpayer at withdrawal his risk-free return is 82.89%. But, realistically, given Peter's DB arrangement and state pension, he should be able to manage this additional retirement income within the basic rate band; as such his risk-free return will be 55.46%. Should he be a higher rate taxpayer when he takes this, then this return becomes 28.03%.

		Now	Future		
			0%	20%	40%
Current account		£2,289	£2,289	£2,289	£2,289
Current account	Reduce by	£2,289			
"Future account"	Increase by	£4,186	£4,186	£3,558	£2,930
Risk-free return?			82.89%	55.46%	28.03%



So, by combining options 1 and 2, making the changes to Peter's salary and dividends and then taking him out of any higher rate liability, his net income for the year will drop by £2,289 per annum, or £190.75 monthly. By doing this, £14,478 has been placed into a pension for Peter.

If he extracts this within the basic rate (after factoring in 25% tax free), this means that he has had to give up £2,289 today to get £12,306 in the future, a staggering 437.6% return. Even assuming that there was no tax-free cash, and for some reason he's an additional rate taxpayer when he takes this money he would get £7,962, a return of 247.88%. That's a compelling rate of return too, and that's an unlikely scenario based on current tax rules.

The key question is, can Peter afford to reduce his net monthly income by £190.75 to do this? Can he live on £3,571 per month instead of £3,762 per month? Is a 5% drop in net income acceptable? A detailed fact find with Peter will uncover what his essential and discretionary spending is. After this is may be the case that he could forego more of his current income to increase his income in the future.

Once current and future spending needs have been determined, **Prudential's Extracting Company Profits tool** shows the impacts of making changes to his remuneration.

Option 3 – Carry forward

As Peter has been a member of a pension arrangement, and has not contributed in the last few years, he can use "carry forward" to make a £160,000 contribution in the current tax year without breaching the annual allowance. This may help Peter's company with its surplus cash. A single employer contribution of say £100,000 would reduce the cash surplus of the company, use up the 2017/18 annual allowance, the full unused allowance from 2014/15 (before it's lost in April 2018) and leave sufficient carry forward allowance to use in future years. A single contribution of £100,000 would have grown to £133,392 by age 60 if we apply the same projection assumptions as used previously in this case study.

It's important to remember that given this level of contribution, the tapered annual allowance could apply. However, Peter's income, and the fact that this contribution is being made by the employer, mean he will be below the threshold income test. For more info on this please see **tapered annual allowance** on the PruAdviser website.

Potential courses of action

- ☑ Rearrange remuneration
- ☑ Use 2014/15 unused annual allowance before it's lost
- ☑ Begin employer pension contributions to produce higher tax savings

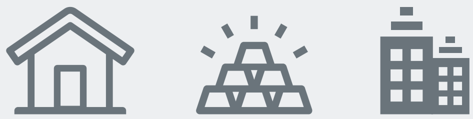
Case study

	2014/2015	Pre alignment 2015/16	Post alignment 2015/16	2016/2017	2017/2018
Annual allowance	£40,000	£80,000	£40,000*	£40,000	£40,000
Pension inputs	£0	£0	£0	£0	£0
Unused	£40,000	£ carried to Post	£40,000	£40,000	£40,000
Unused in 2017/18	£40,000	£N/A	£80,000	£120,000	£160,000

* Carried forward from Pre-alignment

Scenario 3: Surplus cash and tax

Peter would like to know how surplus cash is affected by Inheritance Tax (IHT), Capital Gains Tax (CGT) and Corporation Tax. Piper Ltd holds surplus cash of £300,000. Let's consider the three main taxes in turn.



IHT

Business property relief

Peter has owned his shares in Piper Ltd, which is a private trading company, for more than two years. So, this shareholding would potentially qualify for 100% business property relief (BPR) if Peter dies before selling his shareholding.

He is not contemplating any lifetime gift of shares but, if he was, then there would be additional conditions for deciding whether BPR is due should he die within seven years. These conditions are designed to deny BPR in connection with charges arising on his death if, broadly, the recipient has disposed of the property without replacement or, if it no longer qualifies. The conditions therefore affect the value transferred by a potentially exempt transfer (PET), and the additional tax payable on a chargeable lifetime transfer (CLT) if Peter dies within seven years.

Primary business activities

BPR would not have been available if the business carried on by Piper Ltd consisted wholly or mainly of:

- dealing in securities, stocks and shares,
- dealing in land or buildings, or
- making or holding investments.

The wholly or mainly test gives rise to a 50% rule. There is no suggestion that more than 50% of Piper Ltd's business comprises any of the above excluded categories. Where HMRC encounters a trading/investment hybrid then it will investigate the main activities of the business, and consider its assets and sources of income or gains, over a reasonable period preceding the transfer. Therefore, the level of net profit will not be the only or principal test, and instead the business and its activities will be looked at in the round.

In particular, HMRC will investigate these types of business:

- Caravan sites.
- Furnished accommodation lets.
- Commercial lets.

Excepted assets

In this case, Peter's shareholding in his engineering company will be eligible for BPR, but that's not the end of the story. The IHT legislation prevents taxpayers from getting the benefit of BPR for private assets by confining the relief to assets needed for the business. This is called the 'excepted assets' test where the value of any excepted assets is ignored for the purposes of BPR. That would catch, for example, a trading company which owns a yacht for the personal benefit of the directors – it wouldn't qualify for IHT relief if held personally outside of a company, so it shouldn't qualify if held inside a company. There is no suggestion that Piper Ltd owns such an asset, but it does hold surplus cash which can be considered an excepted asset.

For an asset to avoid being "excepted" it must either:

1. Have been used wholly or mainly for the purposes of the business in question for the last two years, or
2. Be required at the time of the transfer of value for future use for the purposes of the business in question.

In the case of Piper Ltd, we have a company with a turnover of £600,000, cash of £450,000 and £300,000 of that is surplus to any identifiable future business purposes.

It just so happens that those same facts were considered in the following case.

The 'future use' test was considered in Barclays Bank Trust Co Ltd v CIR SpC 158.

A woman died holding half the shares in a company. Her husband held the other half. The company's trade was the sale of bathroom and kitchen fittings, mainly to "trade" customers.

The company's turnover at the time of the woman's death was approximately £600,000. It held £450,000 in "cash" invested for periods of up to 30 days. HMRC accepted that the company needed £150,000 but determined that £300,000 was an "excepted" asset.

The Special Commissioner posed the following question at paragraph 10 of his decision:

"Was the £300,000 cash held by the company required on 23 November 1990 for future use for the purposes of the business? This is a question of fact and on the evidence before me I cannot find that it was so required. I do not accept that "future" means at any time in the future nor that "was required" includes the possibility that the money might be required should an opportunity arise to make use of the money in two, three or seven years' time for the purposes of the business. In my opinion and I so hold that "required" implies some imperative that the money will fall to be used upon a given project or for some palpable business purpose."

Two points are relevant:

1. Only the value of excepted assets is left out – the remaining value (assets) get BPR (assuming the conditions are satisfied).
2. Cash can be as much an "excepted asset" as, for example, an insurance bond. In other words, switching from cash to a bond (or vice versa) should have no effect on availability of BPR.

The need for increased cash buffers

In January 2014, the Institute of Chartered Accountants in England & Wales (ICAEW) issued a **Technical Release containing guidance agreed with HMRC regarding surplus cash**.

The ICAEW reflected that many businesses within the UK are retaining increased cash buffers in case of any further downturn in trade, and accordingly confirmation was sought from HMRC if it would look favourably on surplus cash held in this regard. HMRC responded:

"We understand that due to the financial circumstances in which businesses find themselves, they may choose to hold more cash in case of a potential downturn in trade. We can also confirm that in recent times we have seen this on a more frequent basis where businesses hold cash in excess of what they would traditionally require.

"However, our guidance remains the same, and unless there is evidence which directs us to the fact that the cash is held for an identifiable future purpose, then it is likely it will be treated as an excepted asset. Therefore the holding of funds as an 'excess buffer' to weather the economic climate is not a sufficient reason for it not to be classed as an excepted asset."

IHT summary

- If Peter was to die while holding shares in Piper Ltd, his shares – currently worth £1.5m – would be included in his estate for IHT purposes and eligible for BPR.
- If £300,000 is deemed to fall under the excepted asset rule, then that £300,000 would be excluded when valuing the property qualifying for relief, leaving only £1.2m of BPR.
- If Piper Ltd uses £90,000 to make an employer pension contribution then the surplus cash balance will drop to £210,000 and, it will be just £210,000 which is potentially excluded when quantifying BPR. It is important that Peter is aware of this, but in any event he may be willing to leave the surplus cash inside the business for the time being – if he was to distribute those funds to himself then they would potentially be subject to IHT anyway, unless he then carried out IHT planning (or spent the money quickly on assets that have no value, such as holidays).
- Remember that cash can be as much an excepted asset as, for example, an insurance bond. In other words, switching from cash to a bond (or vice versa) should have no effect on availability of BPR.
- If Piper Ltd had a plan in mind for the surplus cash, then it would be sensible to formalise & review this this in minuted board meetings.

HMRC guidance in its **IHT manual** is:

"In particular, the extent to which cash, bank accounts, building society accounts and similar assets included in the accounts of a business may be excepted assets should always be examined carefully. If the evidence is not considered to be sufficient to support the claim for relief for substantial assets which do not satisfy this test, refer the case to your manager."

In conclusion, if Peter and his accountant have taken the decision to retain surplus cash inside the business for the foreseeable future then an investment of those funds could be considered with the aim of achieving a better return and this would not impact on the IHT position as it currently stands.

CGT

Entrepreneurs' relief

Entrepreneurs' relief is a hugely valuable tax relief for business owners. It provides a 10% tax rate on gains up to £10m which compares very favourably to a 20% rate paid by higher rate taxpayers (this is 28% for higher rate taxpaying individuals for residential property and carried interest). This delivers a maximum tax saving of £1m (i.e. £10m x 10%) at standard rates.

Trading vs non-trading activity

If Peter was to sell his shares, all of the following must apply for at least 12 months prior to the sale:

- ☑ Peter must have held at least 5% of the shares and voting rights in Piper Ltd
- ☑ Peter must have been an employee or director of Piper Ltd
- ☑ The main activities of Piper Ltd must be trading (rather than investment activities)

Peter passes the first two tests. But what about the third test?

HMRC considers that most companies will conduct some activities that are not trading and therefore very few companies are 100% trading. If, for example a company owns an insurance bond then that could be deemed an investment activity. The legislation provides that entrepreneurs' relief is not jeopardised where non-trading activities are "not substantial" and in this regard, HMRC applies a 20% benchmark.

In other words, companies still count as trading if their activities "... do not include to a substantial extent activities other than trading activities". Substantial in this context means more than 20%.

The key question is how a company's non-trading activities should be measured to assess whether they're substantial.

There's no simple formula to this, but some, or all, of the following are among the measures or indicators that might be taken into account in reviewing a particular company's status.

- Income from non-trading activities.
- The asset base of the company.
- Expenses incurred, or time spent, by officers and employees of the company in undertaking its activities.
- The company's history.
- Balance of indicators.

See more information on these indicators in the **HMRC's capital gains manual**.

In the case of Piper Ltd, holding surplus cash or perhaps investing that in a non-income producing insurance bond, it would seem logical to primarily focus on the asset base of the company. In saying that, the first four indicators above should not be regarded as individual tests to which a 20% limit applies.

There are indicators that may be useful in establishing whether there is substantial overall non-trading activity. It may be that some indicators point in one direction and others the opposite way. HMRC will weigh up the relevance of each in the context of the individual case and judge the matter "in the round".

If there is disagreement regarding the status of a particular company, then the issue could be established only as a question of fact before the first-tier tribunal.

In the case of Piper Ltd, if the surplus cash or bond is substantial in comparison with its total assets then this could point towards Piper Ltd not being a trading company for entrepreneurs' relief purposes. With surplus cash/bond of £210,000 and with total assets of £1.41m (£1.5m less £90,000 pension contribution) then, going forward, Piper Ltd should pass the 20% test.

In some cases, in considering a company's assets, it might even be appropriate to take account of intangible assets (such as goodwill) that are not shown on a balance sheet.

Ignoring Piper Ltd for the time being, in general terms, cash amounting to 20% or more of the balance sheet could be problematic. In saying that, HMRC might accept that it's OK, assuming the cash was generated from trading activities. Incidentally, it's possible to have a situation where +20% or more cash generated from trading activities is accepted by HMRC, but if that cash is subsequently actively managed/reinvested, then potentially the sum involved could be treated as a non-trading activity.

Note, however, that **HMRC states** "... the long-term retention of significant earnings generated from trading activities may amount to an investment activity."

CGT summary

When Peter sells his shareholding he will need to ensure that he complies with the 80/20 split so as not to risk his entrepreneurs' relief. Surplus cash of £210,000 should not be a problem given the current (post pension contribution) value of the company. Peter and his accountant should however monitor the position to ensure the 80/20 split is complied with in the 12 months prior to any sale.

Regardless of the 80/20 split, if Piper Ltd invests those funds in an insurance bond, then the company can of course encash the bond, penalty free, when it chooses to do so and spend/distribute the proceeds as desired. Alternatively, the company could assign the bond to Peter at some stage. His accountant could advise on the tax implications at that time.

Corporation Tax

Piper Ltd currently holds surplus cash on deposit. That interest will be received gross and taxed annually at the prevailing Corporation Tax rate. If the company invests in an insurance bond then we need to consider the Corporation Tax implications.

Bonds are taxed under the 'loan relationship' rules, the remit of which extends well beyond insurance bonds. Although complex in nature, in very broad terms, these rules require the taxation treatment of the item in question (in this case an insurance bond) to follow the accounting treatment.

There are a number of accounting standards that a company might use – principally historic cost and fair value.

Historic cost

The bond is simply shown in the balance sheet at the end of the company's accounting period at the original premium amount regardless of the actual surrender value. No annual gain (or loss) is recognised in the company accounts meaning that no Corporation Tax consequences arise. The company achieves tax deferral until there is a disposal event such as full surrender, partial surrender or death of last life assured.

Fair value

In this case, the balance sheet at the end of the accounting period will include the bond at its surrender value at that date. That means the movement in value (either a gain or loss) has been processed through the profit and loss account. That movement has Corporation Tax consequences. The company does not achieve tax deferral since the increase in value will be subject to Corporation Tax (any decrease is potentially relievable for Corporation Tax purposes).

It has been the case that 'small' companies used historic cost with large companies obliged to use fair value. The reason for this is that small companies used a set of less-complicated accounting standards known as the Financial Reporting Standard for Smaller Entities (FRSSE) which permits historic cost accounting.

The FRSSE has now been withdrawn meaning that the majority of large and medium-sized UK entities will apply FRS 102 (see next page) when preparing their annual financial statements for accounting periods commencing on or after 1 January 2016. Only small companies called "micro" entities" – contractor-type companies – will be able to use historic cost accounting for insurance bonds.

Remember that accounting standards are complex and the recognition of the bond in the accounts is, in every case, a matter for the accountant to determine.

FRS 102

FRS (Financial Reporting Standard) 102 is the principal Generally Accepted Accounting Practice (GAAP) in the UK. It replaced the previous Financial Reporting Standards (FRSs) and Statement of Standard Accounting Practices (SSAPs).

FRS 102 and insurance bonds

Under FRS 102, 'basic financial instruments' can be valued at historic cost but a typical insurance bond would not fall within the definition. Insurance bonds falling outside the definition of a basic financial instrument will be accounted for under the fair value regime.

When the company makes a part or full disposal, this is called a 'related transaction'. The profit (or loss) on that is treated as a non-trading credit (NTC) or a non-trading debit (NTD).

Where the bond in question is onshore, then relief is obtained for the basic rate tax deemed paid within the fund. This amounts to 25% of the NTC profit on disposal. That amount can be offset against the company's overall Corporation Tax liability for the accounting period in question. If it exceeds the company's tax liability then the excess is not repayable and neither can it be offset against any prior or future accounting periods.

Small entities

There is a category of business called 'small entities'. A company will qualify if it does not exceed two or more of the following criteria:

- Turnover £10.2m
- Balance sheet £5.1m
- 50 employees

These entities are required to use the FRS 102 accounting rules outlined above (i.e. fair value for a typical insurance bond) but will have reduced presentation and disclosure requirements.

Micro entities

Very small companies as explained above are able to continue with historic cost. A company qualifies if it does not exceed two or more of the following criteria:

- Turnover £632,000
- Balance Sheet total £316,000
- 10 employees

Under this regime, no assets can be measured at fair value or a revalued amount and instead must be held at cost.

Normal bond chargeable event rules do not apply to companies. Following the Finance Act 2008, the loan relationship rules apply and not chargeable event gain rules. As mentioned above, the loan relationship rules have a much wider remit than just investment bonds.

Corporation Tax summary

Piper Ltd employs 20 people, has an annual turnover of approximately £600,000 and currently has an overall balance sheet total of £1.5m. So, Piper Ltd is not a micro entity and an insurance bond investment will need to be accounted for under fair value rules. FRS 102 will apply and Piper Ltd will be deemed a 'small' entity for presentation and disclosure purposes.

With interest rates at such a low level, companies such as Piper Ltd are attracted by an insurance bond solution with the aim of achieving a better return if that can be delivered in an environment of low volatility, as those funds will be required at some point for business purposes.

In the case of an onshore bond, Piper Ltd would be the owner with Peter as life assured. At the end of each accounting period, the bond will be revalued in the accounts and the increase in value will be taxed at the prevailing Corporate Tax rate (currently 19%). This increase is known as a 'non-trading credit' (NTC). There is no relief at this point for tax suffered with the fund. A decrease in value would, incidentally, be known as a 'non-trading debit' (NTD) and that would be potentially relievable for Corporation Tax purposes.

If Piper Ltd subsequently fully encashes the bond for profit, then this is known as a 'related transaction'. The profit will give rise to an NTC and at this point relief for tax paid within the onshore bond fund will be recognised. In essence the NTC is subject to Corporation Tax but tax treated as paid can then be set against the company's Corporation Tax liability for the accounting period in which the disposal occurs. If it exceeds the company's Corporation Tax liability, the excess is not repayable. The 'tax treated as paid' is currently calculated as follows – profit from the contract (PC) x 20/80.

For completeness, we should also address the question of whether Piper Ltd's investment into an insurance bond is covered by the Financial Services Compensation Scheme (FSCS) in the event that the UK insurer is declared in default by the FSCS.

Most insurance policies issued in the UK are covered by the Scheme. A UK life insurance bond would fall within the category of long-term insurance meaning that the FSCS can pay up to 100% (effective from 3 July 2015) of the value of the claim (with no maximum amount). With that in mind, can it apply to a corporate investor?

Currently, the answer lies in the Compensation (COMP) rules.

COMP 4.2.2R lists the type of claimants who can't claim compensation from the FSCS, and this does say that large companies are not eligible to claim from the FSCS. However, **COMP 4.3.2R** confirms that if the claim is in relation to a 'long-term insurance contract' then the list of excluded claimants is much smaller than the list held in COMP 4.2.2R. The effect being that even large companies are able to claim if their claim is in relation to long-term insurance contracts.

The rules in relation to the FSCS compensation available following the default of an insurer are found in the PRA's Policyholder Protection Rules.

As established earlier, Piper Ltd for these purposes is defined as a small company rather than a large company.

Potential courses of action

- ☑ Invest surplus cash with the objective of achieving a better return
- ☑ If there are business plans for the surplus funds, then these should be recorded in board minutes
- ☑ Continue to monitor the level of surplus funds, in case Peter decides to sell his shares in the future

Scenario 4: IHT and university planning

In considering his inheritance from his late mother, Peter wants advice on IHT and deeds of variation, trustee investment and taxation, and planning for his daughter's university fees.

Peter's inheritance from his late mother

Peter inherited OEICs and his mother's property 12 months ago as the only beneficiary of her will.

Her house was worth £170,000 and was subsequently sold. The cash is sitting in Peter's bank account.

The OEICs had a probate value of £22,000 and are now worth £30,000. The OEICs are now registered in his name.

Deed of variation

Peter could consider a deed of variation (DOV). This does not mean that Peter would vary his mother's will as such but instead he is redirecting his inheritance which is treated for IHT purposes as if it has been carried out by his late mother.

In general law, a variation takes effect from the date of the instrument and if it gives rise to a loss to Peter's estate, there is a transfer of value. However, provided that the conditions of IHTA84/S142 are satisfied, then it will be treated for IHT purposes as if the redirection had been made by the deceased (his mother), and so the redirection of property is not a transfer of value by Peter. In other words he is not making a gift subject to the seven-year rule.

The DOV must be made within two years of the date of death. The only stipulation in IHTA84/S142 about the form of an instrument is that it must be in writing. It does not have to be a formal deed or even writing that is signed as a deed. HMRC can accept a letter or note from the beneficiary (Peter) redirecting his/her inheritance as a valid variation so long as the document conforms to the guidelines and otherwise meets the conditions of IHTA84/S142.

Peter could therefore 'vary away' £170,000 plus the OEIC portfolio under DOV rules to his 12-year-old daughter absolutely and for IHT purposes that would not be treated as a potentially exempt transfer (PET) by him but treated instead as if his mother had left those funds directly to his daughter. The potential downside of course is that she would have full access to those funds when she turns 18 and Peter would have no control over that.

Peter could therefore 'vary away' his inheritance into a discretionary trust where the trustees can accumulate income and may pay income or capital to a beneficiary at their discretion. For IHT purposes it would be treated as if his mother had set up the trust meaning that Peter is not making a chargeable lifetime transfer (CLT). The consequence of this is that Peter can be a potential beneficiary of the trust without infringing gift with reservation issues.

CGT on the OEIC portfolio

The probate value was £22,000 and it is now worth £30,000. How is this post-death gain dealt with? There are provisions in the CGT legislation dealing with DOV (S62(6)-(9) TCGA 1992) which effectively state that Peter will not be making a disposal for CGT purposes if he carries out the DOV. Therefore, for future CGT purposes the trustees' base cost will be £22,000. This will be the case if the instrument contains a statement that S62(6) applies. In this case, however, if Peter has an unused CGT exemption, then the £8,000 post-death gain falls within his annual exemption meaning that he can exclude S62(6) from applying. This means that:

- his disposal to the trustees triggers a gain which is tax free within his annual exemption
- the trustees then acquire a CGT base cost of £30,000 for future disposals (rather than £22,000)
- this will reduce any future capital gain on a later disposal of the OEICs by the trustees.

Budget 2015

In the first budget of 2015, the government announced a review of the use of DOV for tax purposes. The scope of the review was restricted to the use of DOV for tax purposes only and did not consider their use as a legal instrument, which is a matter for the Ministry of Justice.

Following responses to this it was announced in the Autumn Statement of 2015 that the government would not introduce new restrictions on how deeds of variation could be used for tax purposes but would continue to monitor their use.

Trust fund

The trustees can continue to hold the OEIC portfolio. OEICs must distribute income and therefore the trustees will receive either interest or dividends (from equity funds). Interest from OEICs are paid gross as of 6 April 2017. Previously this was paid net of 20% tax.

With regard to dividends, the new Dividend Tax Allowance applies from April 2016 but this is not applicable to this trust.

Settlor interested

This trust will be 'settlor interested' for Income Tax purposes because Peter is a potential beneficiary.

This means that Peter is taxable on the income arising even if he doesn't receive it. The trustees will receive the income and be taxed on it, and then Peter will get credit for that tax paid to set against his own Income Tax liability. The trustee rates of tax are as follows:

2017/18	
Trust income up to £1,000*	**Tax rate**
Dividend-type income	7.5%
All other income	20%
Trust income over £1,000	**Tax rate**
Dividend-type income	38.1%
All other income	45%

* If the settlor has more than one trust, this £1,000 is divided by the number of trusts they have. However, if the settlor has set up five or more trusts, the standard rate band for each trust is £200.

There are no settlor interested rules for CGT. Trustees only have to pay CGT if the total taxable gain is above the trust's tax-free allowance (called the Annual Exempt Amount).

The tax-free allowance for trusts is:

- £5,650 (this is reduced for multiple trusts with a minimum of 1/5th of the available amount)
- £11,300 if the beneficiary is disabled

If there's more than one beneficiary, the higher allowance may apply even if only one of them is disabled.

The remaining amount is taxed at the current rate of Capital Gains Tax for trustees in the 2017/18 tax year:

- 20% for trustees or for personal representatives of someone who has died (not including residential property).
- 28% for trustees or for personal representatives of someone who has died for disposals of residential property.

Peter may consider the Income Tax settlor interested rules cumbersome from a self-assessment perspective and this might therefore partly influence consideration of a non-income producing bond as a trustee investment rather than income producing investments.

Offshore bond

Given that Peter wants to help fund his daughter's future university costs, he might decide to nominally earmark the trust for those purposes and consider a trustee investment into an offshore bond. This is a non-income producing investment which is not subject to CGT.

This is how it's taxed:

- No tax due until a chargeable event occurs and a gain is calculated on it.
- While Peter is alive, chargeable event gains fall back on him for tax purposes.
- Trustees can take 5% cumulative withdrawals and pay this capital out to a beneficiary.
- Trustees could assign (or gift) segments to his daughter when she is at university to access her personal tax position if she subsequently encashes. The gift from the trustees would not trigger a chargeable event.

With regard to assigning offshore bond segments to his daughter when at university, remember that since 6 April 2015 the starting rate band is £5,000 taxed at zero%.

Also, the Personal Savings Allowance (PSA) came into effect from 6 April 2016, which means that:

- non and basic rate taxpayers can earn up to £1,000 in savings interest tax free.
- higher rate taxpayers have a £500 PSA and additional rate taxpayers have no PSA.

So, there are planning opportunities – for savings income only. This is defined in S18 ITA 2007 and includes insurance bond gains.

With that in mind, let's consider the situation of Peter's daughter when she is at university. If she has taxable non-savings income which exceeds the starting rate limit, then the zero% starting rate for savings will not be available. That is unlikely to be the case for a student.

Example

The trustees of the DOV trust purchase an offshore bond for £200,000 comprising 100 segments at £2,000 per segment. After six years, at which point Peter's daughter starts attending university, the bond is worth £270,000. Each segment is worth £2,700.

The trustees then gift six segments worth £16,200 to Peter's daughter. There will be no chargeable event for Income Tax purposes because the assignment was not for money or money's worth. There will be no exit charge for IHT purposes because the trust fund is within NRB limits.

If his daughter subsequently decides to encash those segments in full, her tax position would be as follows (assuming no further growth post-assignment):

Proceeds	£2,700 x 6 = £16,200
Cost	£2,000 x 6 = (£12,000)
Chargeable event gain	£4,200

The daughter can use her personal allowance and/or zero% savings rate and/or PSA to ensure that no tax is payable on the gain.

The result is gross roll-up during the term with no tax payable on encashment.

So, there are planning opportunities for those on low or zero earned income.

Peter's inheritance from his late mother – summary

Peter is aware of the need to carry out IHT planning and this need is exacerbated by the £200,000 of funds inherited from his mother. He should consider a DOV now, before his two-year window elapses.

If he 'varies away' his inheritance into a discretionary trust then he can potentially benefit from that trust without gift with reservation problems (for IHT purposes, his late mother will be the settlor rather than him).

Given Peter's desire to help fund his daughter's university costs in a few years then Peter could notionally 'earmark' the trust fund for this purpose – albeit that he remains a potential beneficiary should the need arise. The discretionary trust route therefore offers Peter the opportunity to carry out IHT planning while retaining control and retaining the ability to benefit personally. Peter can be a trustee.

The OEICs are currently showing an £8,000 gain over probate value and, if Peter has an unused CGT exemption then he should exclude S62(6) TCGA 1992 from applying meaning that he triggers an £8,000 gain, covered by his annual exemption when transferring his shares into the trust. The trustees base cost for future disposals will therefore be £30,000 rather than £22,000. This means that if the trustees dispose of the OEIC shares for circa £30,000 the capital gain will be nil/negligible and easily covered by the trustees' annual CGT exemption.

If Peter wants to prevent income arising and simplify the administration of the trust then he might consider a trustee investment into a non-income producing investment bond. The trustees could take cumulative 5% tax-deferred withdrawals and pass these onto his daughter. For amounts in excess of this, any gains would crystallise on Peter who is the settlor for non IHT purposes.

When his daughter is at university, she is likely to be on zero or low income and therefore her tax position could be accessed by the trustees assigning segments to her (at their discretion) and then she could subsequently encash those segments. If, for example, she was on zero income, then her personal allowance plus her zero% starting rate band (£5,000 currently) plus her savings allowance (£1,000) would all be available to set off against offshore bond gains. The broad strategy therefore would be to restrict withdrawals to 5% limits while his daughter is under 18 and thereafter assign segments to her at the discretion of the trustees.

Potential courses of action

- ☑ Contact a solicitor with a view to carrying out a deed of variation into a discretionary trust
- ☑ Consider the CGT implications regarding the £8,000 post death gain on the OEIC portfolio
- ☑ The trustees should consider a non-income producing offshore investment bond

Scenario 5: Pension vs ISA or buy-to-let

Peter wants advice on the benefits of a pension versus an Individual Savings Account (ISA) or a buy-to-let property. He wants to know more about how accessibility, investment risks and costs can affect future savings.

Key information

- Peter's change in marital status from married to divorced will undoubtedly result in a need to reconsider his future. Affordability will be a major factor in his ability to save for the future; however, assuming he has some disposable income, he will face the decision as to how best to invest that money for the future.
- Peter has experience of both ISAs and pensions – as explored earlier, Peter is a member of a Defined Benefit pension scheme. He's heard that a buy-to-let property may be an alternative option, so he wants to consider the pros and cons of all three options for his future savings.
- In the current market, Peter could look at many different options, but we'll stick to looking at these as some of the most popular. As he's over the age of 39, the Lifetime ISA (LISA) is not applicable for Peter.
- To help structure the conversation around the various savings options, let's assume that Peter doesn't have the degree of autonomy required to change the shape of his remuneration package (as per the previous section on extracting company profits) and that Peter is looking to save his own money.

Investment wrappers

The conversation around which wrapper or combination of wrappers are suitable for a client should always be on an individual case-by-case basis, as all clients have different needs, expectations, risk profiles and circumstances. However, generic comparisons can be effective in establishing the major consideration points.

In addition to pensions and ISAs, pension freedoms have resulted in many people considering withdrawing their existing pension funds to take advantage of alternative investments, such as the purchase of buy-to-let property, so we will also have a look at this issue later.

First, let's compare pensions and ISAs. The key considerations are:

- Tax efficiency
- Contribution limits
- Accessibility
- Investment risk
- Costs

Tax efficiency

One of the main advantages of a pension is tax efficiency – investors receive tax-relief on their contributions, up to a maximum of the greater of £3,600 or 100% of relevant earnings. So, for every £1,000 of pension contributions £1,250 will be invested in the pension (assuming that basic rate tax relief at source applies). Higher or additional rate taxpayers can claim the balance of their marginal rate through their self-assessment return, which results in a further £250 tax benefit to higher rate taxpayers and £312.50 for additional rate payers.

Pensions can also be used to manage Adjusted Net Income to avoid the various tax traps such as child benefit charges for those in receipt of child benefit but earning in excess of £50,000; and those earning above £100,000 who suffer a reduction in their personal allowance.

While funds are invested within a pension plan they will grow tax free (no income or capital gains tax).

When the pension holder subsequently elects to access their pension, they are subject to Income Tax on most of the fund (25% can usually be paid tax free). However, as most are likely to have a smaller income in retirement, they will usually pay a lower rate of tax at retirement than they do in their working lives (or none at all, if all the income falls within the personal allowance).

ISAs do not receive the initial tax boost provided by pensions' tax-relief, but they do enjoy the same tax treatment while invested. However, the funds can be accessed tax free, and at any time (unlike pensions which can only usually be accessed after reaching 55 (or 57 from 2028)).

As stated above, the tax treatment of the funds while invested in ISAs and pensions is the same (no Capital Gains Tax or Income Tax), but the treatment is different at the contribution and withdrawal stages.

Contribution

Tax treatment of ISA contributions is straightforward – the payments made to ISAs are usually made from income that has already been subjected to tax and National Insurance. There's no tax relief on the contributions.

On the other hand, pension contributions enjoy tax relief. But before this can be addressed we need to consider that Peter may have the option to make employer and/or employee contributions. He also may have the option of giving up part of his salary in return for an employer pension contribution, commonly referred to as "salary sacrifice" or "salary exchange".

As an employee of his own limited company, Peter could make an employee contribution of, say, £10,000, or he could make an employer contribution. The employee contribution would be paid from income after Income Tax. National Insurance (both employer and employee) has been applied, and although Income Tax relief will be given at basic rate (with the balance of higher rate/additional rate tax, if applicable, being recovered via self-assessment returns) the National Insurance contributions are not recoverable.

Alternatively, an employer pension contribution is paid directly by the employer (gross). This is regarded as a business expense and as such reduces the company profit and hence the company's Corporation Tax bill. There is no National Insurance contribution payable on the employer's pension contribution.

The employee can elect to reduce their salary in return for an employer's pension contribution. The resultant saving in National Insurance can be used to increase the pension contribution or provide cost savings to the employer and/or the employee.

Although sacrificed salary will be taken into account for the calculation of "threshold income" for tapered annual allowance, this would not be a problem for Peter as his earnings are not at this level. The Chancellor also announced in the 2015 summer budget that the government would be monitoring salary sacrifice arrangements but there are no obstacles at present.

In Peter's case (let's ignore the dividend income) the following example covers the different results produced by an employee pension contribution against a sacrifice of £10,000 salary in return for an employer's contribution (where the savings in National Insurance are used to increase the pension contribution).

Employee

	Pre sacrifice	Post sacrifice	Change
Salary	£50,000	£38,966	- £11,034
Less Income Tax	£7,700	£5,493	- £2,207
Less National Insurance (Class 1)	£4,524	£3,696	- £828
Net Income	£37,776	£29,777	
Less Contribution Paid Net	£8,000	£0	
Take Home Pay	£29,776	£29,777	£1
Pension Pot	£10,000	£12,557	£2,557

Employer

	Pre sacrifice	Post sacrifice	Change
Employer Pension Contribution	£0	£12,557	£12,577
Plus Salary Paid	£50,000	£38,966	-£11,034
Plus Employers NI (Class 1)	£5,773	£4,251	-£1,522
Cost to employer	£55,773	£55,774	£1

Peter would still have his £10,000 of dividend income to take into account. By sacrificing his salary down to £38,966, this means that after the dividend zero rate that £1,034 of dividends that were in higher rate taxation (32.5%) are now being taxed at basic rate 7.5%. So he would also save £258.50 in dividend tax by making this sacrifice. So he would also save £258.50 in dividend tax by making this sacrifice.

So this means Peter has £2,557 more in his pension, and an increase in take-home income of £258.50, with no increase to the costs of Piper Ltd.

Contribution limits

While pension contributions are unlimited, tax relievable contributions by an individual or third party on their behalf are limited to the greater of 100% of "earnings" or £3,600. There is however an annual allowance of £40,000 (or £10,000 money purchase annual allowance (MPAA), if pensions have been flexibly accessed) above which an annual allowance charge is made. The annual allowance charge effectively nullifies the tax advantage of the excess contributions. At the time of writing there are proposals to reduce the MPAA to £4,000 but there is currently no legislation.

We should also be aware that those with "threshold income" in excess of £110,000 and "adjusted income" in excess of £150,000 will be subject to a 50p reduction in the standard annual allowance for each £1 earned over £150,000, subject to a minimum annual allowance of £10,000. However, due to the level of current income this will not affect Peter at this time. We should also be aware that it is possible to "mop-up" unused annual allowance using "carry forward". As such, few will find their (or their employer's) pension contributions curtailed.

ISAs have a tax year limit of £20,000 (2017/18) – junior ISAs are limited to £4,128. However, these are standalone contribution limits and once the tax year passes they are gone.

Accessibility

The pension freedom rules introduced from April 2015 have had a dramatic effect on the accessibility of defined contribution (DC) pension plans. Although defined benefit schemes (DB) have no access to new pension flexibilities, DC schemes have effectively had the withdrawal "shackles" removed for those aged 55 and over. In essence, DC pension holders over age 55 can now take their pension in whatever form suits their needs, including accessing the whole pension pot as a lump sum.

Care should however be exercised, as part of the pension (excluding the tax-free Pension Commencement Lump Sum, or the tax-free part of an Uncrystallised Fund Pension Lump Sum) will be assessable against Income Tax in the year of withdrawal and may result in substantial tax bills if the client does not exercise care.

Accessing pensions flexibly may also result in the application of the MPAA, reducing future tax-efficient pension savings to £10,000 (as previously mentioned this may reduce to £4,000) per annum.

It is important to note that taking a Pensions Commencement Lump Sum and designating the balance to drawdown, without drawing an income from the drawdown pot, is not classed as flexibly accessing your pension, neither is the payment of "small pots". Additionally taking DB benefits from your scheme or a traditional annuity will also not trigger the MPAA.

ISAs have the advantage of being accessible tax free. No Income Tax or Capital Gains Tax will be charged on withdrawals, although once withdrawn the withdrawn funds may be taxable on subsequent interest/growth depending on where the funds are subsequently placed.

Investment risk

It is not the investment wrapper that drives the investment risk, but the investments retained within the investment wrapper.

Pensions and ISAs can both hold investments, which can be cautious or speculative; the choice sits with the investors. The standard mantra is the more speculative the investment, the greater the risk of investment gain (or loss). Most pensions and ISAs offer an extensive investment choice, allowing both to be tailored to the individual investor's requirements.

However, many risk factors remain which need to be considered, including general economic risk (government fiscal and monetary policy) and market risk (systemic and non-systemic).

Costs

The product and investment cost of pension provision can vary considerably. The range varies from a basic stakeholder pension which will provide a limited choice of investment (although this may be sufficient for most clients) at an annual management charge (AMC) of 1.5% for the first 10 years and 1% thereafter; up to a fully autonomous Self Invest Personal Pension Plan (SIPP), the cost of which will be dependent on investment activity, but will in most cases be significantly higher than a stakeholder-type plan.

The type of ISA selected will influence the charges. Cash ISA charges are not transparent as the charges are reflected in the interest rate payable, while investment-based ISAs will detail the management charges of the selected investment.

Years of competitive and regulatory pressure on charges have resulted in a charging structure which is largely transparent and considered by many as competitive (although this point often divides opinion) in respect of both pensions and ISAs.

Further considerations for how this impacts on Peter

Peter would have to consider the above options based on a full holistic analysis of his requirements, including:

- Current situation
  - income and expenditure (including his current commitment to his daughter)
  - current tax considerations
- Future needs
  - daughter's education costs
  - Peter's short to medium-term savings requirements
  - retirement provision
  - anticipated future tax considerations (both personally and legislatively)
- Risk profile

However, it would be fair to say that Peter should not ignore the tax advantages of pensions. We have discussed various methods of taking advantage of this including:

- Changing the shape of remuneration to allow for an employer's contribution at very little cost to Peter and his company.
- Using salary sacrifice to facilitate an employer contribution that is not only tax efficient but saves on National Insurance costs.

If the above is not available to him (and/or in addition to these options) Peter could also consider making more conventional member contributions, either from his net income or perhaps reconsidering his previous choice of savings wrapper. Given the pension freedoms legislation gives flexible access from age 55, Peter could boost his savings (and his net income) by "drip-feeding" his current ISA into a pension.

Switching wrappers

Peter (dependent on the shape of his income) could benefit from:

- higher rate tax relief on pension contributions
- tax-free growth on the invested funds
- a portion of his basic rate tax band still available to manage the tax position of subsequent pension withdrawals – when he retires.

Say we feed Peter's £70,000 ISA holdings into a pension over the next five years.

The below would therefore generate an additional £15,625, for doing nothing other than switching tax wrapper.

Year	Tax	ISA Portfolio	Pension Pot	Disposable Income*
0	Higher	£70,000	£0	£0
1	Higher	£56,000	£17,500	£2,250
2	Higher	£42,000	£35,000	£2,250
3	Higher	£28,000	£52,500	£2,250
4	Higher	£14,000	£70,000	£2,250
5	Higher	£0	£87,500	£2,250
Result				
		-£70,000 from ISA	£74,375 after tax (Assume withdrawal at net 20% – over a number of tax years)	£11,250 extra disposable income

* The additional disposable income of £2,250 is generated through the tax saving on the salary and dividends. The £17,500 gross contribution to a relief at source scheme increases Peter's basic rate band from £33,500 to £51,000. Including the personal allowance of £11,500 this means that his higher rate threshold has moved from £45,000 to £62,500, so all of his income is in the basic rate as detailed below.

	Before		After	
Salary	£50,000		£50,000	
Dividends	£10,000		£10,000	
Personal Allowance	£11,500		£11,500	
Income Subject to Tax	£48,500		£48,500	
Income	**Tax Due**		**Tax Due**	
20%	£33,500	£6,700	£38,500	£7,700
40%	£5,000	£2,000	£0	£0
Dividends	**Tax Due**		**Tax Due**	
0%	£5,000	£0	£5,000	£0
7.5%	£0	£0	£5,000	£375
32.5%	£5,000	£1,625	£0	£0
	Total Tax	**£10,325**	**Total Tax**	**£8,075**

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£10,325 of tax was due before, whereas making the £14,000 net/£17,500 gross pension contribution not only gains £3,500 tax relief at source in the pension, it also saves Peter tax of £2,250.

This is at no monetary cost to Peter as this is being funded from his ISA. There is of course a cost in terms of access as he will not be able to access this until he is 55 (four years away).

He could access the ISA at any time, although drip feeding this over five years means that there is still ISA money to access should Peter need to.

Additional pension contributions

Assuming the options previously discussed (employer's contributions as part of reshaping remuneration / dividend swap / salary exchange and so on) are not available, Peter could also consider making more conventional member contributions. He has sufficient lifetime allowance (LTA) to allow additional pension contributions. Although the LTA reduced to £1m in 2016/17, the LTA will increase by the Consumer Prices Index from April 2018.

Year	Used	Unused	Available in 2017/18	Available in 2018/19
2014/15	£0	£40,000	£40,000	£0
2015/16	£0	£40,000	£40,000	£40,000
2016/17	£0	£40,000	£40,000	£40,000
2017/18	£0	£40,000	£40,000	£40,000

Lifetime Allowance
Defined Benefit Pension @ NRD (2026/27) £38,000 x 20 = **£760,000**
Three-year gap fill = 3 x £38,000 = **£114,000** (although factoring in growth in the income years this was £110,381 earlier).
Projected LTA to 2026/27 (CPI @ 2.5%): £1,248,863
Approx. LTA headroom if gap fill actioned: £374,863

So should he wish to increase tax efficiency of his income, then Peter still has plenty of allowance to make further contributions whilst he can. After he retires the opportunity will be lessened as he will likely be limited by the MPAA, although it's also likely he will have no relevant earnings and be limited to £2,880 net / £3,600 gross per annum.

Buy-to-let

Many commentators have raised the potential of using the pensions freedom legislation to withdraw money from their pension to purchase residential property. Given the popularity of purchasing residential property within the UK, it is an option which must be addressed.

Tax efficiency

In the tax efficiency stakes buy-to-let is the least tax efficient of the investment options we have covered. No tax relief is given on the initial investment; in fact, dependent on the property purchase price there may be Stamp Duty Land Tax to be paid on the purchase price. Any income from rent is liable to Income Tax and when the investor finally decides to liquidate their investment, any profit will be liable to Capital Gains Tax.

Historically, it was possible to offset some of the costs, such as a set percentage of rent for replacement of furnishings and tax relief on mortgage interest payments at the owner's marginal rates. However, in the summer Budget of 2015, the landscape for buy-to-lets changed. Now landlords can only deduct the actual costs incurred for "wear and tear" and they will no longer be able to deduct all of their finance costs from their property income to arrive at property profits. They will instead receive a basic rate reduction from their Income Tax liability for finance costs.

Landlords can obtain to obtain relief as follows:

- 2017/18 75% finance costs deduction and 25% given as a basic rate tax reduction.
- 2018/19 50% finance costs deduction and 50% given as a basic rate tax reduction.
- 2019/20 25% finance costs deduction and 75% given as a basic rate tax reduction.
- 2020/21 all financing costs incurred by a landlord will be given as a basic rate tax reduction.

Contribution limits

With buy-to-let there are no contribution limits as such. However, if the investor plans to partially fund the purchase with a mortgage, most lenders require a deposit from the investor's own funds of between 20% to 40% of the purchase price (exclusive of the purchase costs such as Stamp Duty Land Tax). Interest rates will usually be higher than a standard residential mortgage and products with a lower deposit requirement are usually noticeably higher.

Furthermore, the changes to relief on borrowing costs has meant lenders now require an increased multiple of rent against mortgage costs too.

Accessibility

For buy-to-let, the ability to liquidate the funds invested will depend on finding a buyer for the property at the point the funds are required. Also, the sale of a property is usually an "all or nothing event". As such, realising only part of the invested capital would be difficult. In the UK there is a strong market for residential property but even the UK market suffers from its darker times. A buyer can usually be found, but the price they are willing to pay may not meet expectations. The time it takes to sell a property can also be a factor, with quick sales usually resulting in a lower price being achieved. Also, the tenant situation may have an impact on price – for a potential investor a property with a current tenant may be a good thing, but for a buyer hoping to use the property as their main residence, the delay in removing a current tenant may have an impact on the price they are willing to pay.

Investment risk

The risk inherent with direct investment property will be driven by many factors (in addition to the above access risk factor) including:

- **Tenant risk** – lack of tenant, non-payment by tenant, damage by tenant.
- **Interest risk** – property that is mortgaged is particularly sensitive to fluctuations in interest rates, both in terms of mortgage payments and the capital value of the property.
- **Diversification risk** – a unit of property can be expensive, so many clients have a limited number of properties. This increases the risk associated with this type of investment. A diversified property portfolio should cover different property types and geographical locations (including non-UK properties). Unfortunately most direct property investors seldom achieve this level of diversification.

Costs

In respect of buy-to-let, although the charges are transparent, they can be extensive and wide-ranging. They can include:

- Solicitor's fees at purchase
- Survey fees, including structural surveys and repair surveys
- Stamp Duty Land Tax (SDLT) (or Land and Buildings Transaction Tax in Scotland)
  - Higher rates of SDLT for additional properties (Additional Dwelling Supplement in Scotland)
- Agents fees (unless the investor is happy to arrange leases/deposit/rental payments directly)
- Advertising costs to secure tenants and legal costs to ensure appropriate lease documentation
- Recovery costs (recovery of unpaid rent, removal of tenants)
- Furniture/goods costs (even if renting as unfurnished, some basic items such as white goods need to be provided)

- Insurance (buildings, public liability and perhaps cover for central heating and so on)
- Repair and maintenance costs (not covered by insurance contracts)
- Estate agency costs on sale
- Solicitor's fees on sale

The combination of the above can have a significant impact on the overall yield of a buy-to-let investment.

Although direct investment in commercial property is permissible within a pension, the direct purchase of residential property would usually result in severe penalties. However, such is the popularity of purchasing residential property in the UK, it's not surprising that many people are considering 'cashing out' their pension to purchase residential buy-to-let properties.

Peter's options

A few years have now passed and Peter is aware that, as he is now age 55, the pensions freedom legislation allows him to access his pension fund. He is now considering using some of his pension to buy a buy-to-let property as he believes the rental income will help him in retirement. Peter's total pension pot is worth approximately £750,000.

Walking past his local estate agent, he takes a shine to a £90,000 property in the window. He calls his pension provider and requests sufficient immediate withdrawal from his pension pot to buy the property, as he believes this may provide better returns than leaving the money within his pension.

The scheme's reaction to this request would be to advise Peter that this would not be possible as his pension is a Defined Benefit scheme and as such, pension flexibility is not offered. Peter would have to transfer his deferred DB scheme to a DC scheme to be able to access the funds flexibly. As discussed above, this is not a decision which should be taken lightly, moving from a safeguarded benefit where the scheme is taking the investment risk to a DC pension where the investment risk sits totally with the pension holder needs serious consideration.

Before his scheme would allow the transfer they would insist that Peter seeks the advice of a Pension Transfer Specialist who has the appropriate knowledge to discuss the implications of the proposed transfer. This would incur a cost. In generic terms, the advice would likely be that Peter should remain in the DB scheme and not proceed with the transfer.

In Peter's case, he would need to transfer his main DB scheme benefits to an individual scheme to provide flexible access, as his scheme is unlikely to provide access to flexible options. Assuming he does transfer, he already has earnings of £50,000 pa and dividends of £10,000pa (assuming we have not yet changed the shape/amount of Peter's taxable income), the pension withdrawal will result in an additional tax bill. There are also complications as the level of income needed in one go will take Peter into additional rate tax. So to increase his net income by £90,000 he will actually need to crystallise £135,667.92 of his pension pot.

Assuming 2017/18 tax rates:

Tax due (pre pension withdrawal)

		Rate	Tax Due
Personal Allowance	£11,500	0%	£0
Non-savings income in Basic Rate	£33,500	20%	£6,700
Non-savings income in Higher Rate	£5,000	40%	£2,000
Dividends at zero rate	£5,000	0%	£0
Dividends in higher rate	£5,000	32.5%	£1,625
Totals	**£60,000**		**£10,325**

Tax due (after withdrawal)

		Rate	Tax Due
Personal Allowance (lost given taxable income)	£0	0%	£0
Salary in Basic Rate	£33,500	20%	£6,700
Balance of non-savings income above PA within HRTB	£16,500	40%	£6,600
Taxable portion of withdrawal within HRTB	£100,000	40%	£40,000
Taxable portion of withdrawal within ARTB	£1,751	45%	£788
Dividends at Zero Rate	£5,000	0%	£0
Dividends in Higher Rate	£0	32.5%	£0
Dividends in Additional Rate	£5,000	38.1%	£1,905
			£0
Totals	**£161,751**		**£55,993**

Based on the existing salary and dividend combination (ignoring NI as this will be the same in both instances and does not affect the calculations), Peter has a net income of £49,675 (£60,000 less £10,325 in tax).

After crystallising, Peter's net income is £105,750.02 (£161,750.94 - £55,992.92).

Based on this, Peter's net income has increased by £56,083.02 (£105,750.02 - £49,675), so this is short of the target. However, there is 25% tax-free cash from the pension to take account of. Handily this equates to £33,916.98, which therefore meets Peter's targeted purchase price of £90,000 (£56,083.02 + £33,916.98).

In reality, because the withdrawal is likely to be subject to Emergency Month 1 tax (commonly referred to as emergency tax) the initial tax bill for the pension withdrawal is likely to be nearer £44,713, so Peter will net £91,495 (£135,568 - £44,173). Therefore Peter will initially have more than he needs and will have to sort out his tax via self-assessment.

We will assume Peter has additional cash to cover the costs of buying and furnishing the house (assuming he wants to let it furnished).

A number of costs need to be taken into account. These may be:

- Stamp Duty Land Tax (£0 in this case, but had the property been above £125,000 this would have been chargeable), however the additional rate of 3% will apply, so this will equate to £2,700
- £1,500 solicitor/survey fees
- £2,000 furniture costs

In addition to cashing in £135,667.92 of his pension he needs to find £6,200 to cover the short-term cash flow issue caused by the additional costs and has paid more in tax (because he lost his PA and pushed some of his dividends (and part of the pension withdrawal) into ART). Costs so far are £141,867.92.

Peter has elected to rent out the property via a letting agent, as he doesn't want the hassle of advertising the property, interviewing/vetting prospective tenants, arranging tenancy agreements, collecting rent etc. They charge 15% for the services they provide. They have managed to obtain an attractive rental of £525 per month – this is good for a £90,000 property.

Of course, Peter also has to pay tax on the rental amount, after the letting agent fee, so his annual income from the property is £6,300 - £945 (15% letting agent fee) = £5,355 gross to Peter.

However, in year one this will be liable to part higher rate and part additional rate tax. Even if we ignore this problematic first year, the income will likely be liable to 40% so he will receive only £3,213 net.

This may sound attractive; however, there are a number of issues Peter needs to consider:

As a net income, relative to his outlay, the net yield from the rent is actually only 2.26% (£3,213/£141,868). This is perhaps not as attractive as it initially appeared.

Further points to note:

- CGT might be payable on any capital gain when the property is sold; this will be at the residential rates of 18% and 28% for basic and higher (and additional) rate taxpayers respectively.
- On Peter's death, IHT may be payable on the property.
- There is no guarantee that the property will always have tenants, even short 'void' periods would have a significant impact on the return. For example, only one void month each year would reduce the above yield to below 2.04%.
- There could be maintenance and/or repair costs (tenants may not always look after the property as the owner would wish). Large repairs like roof replacement, replacing central heating boilers can be expensive and will certainly impact on that yield.
- If the tenants can't get in contact with the letting agent on a Saturday night, when the boiler breaks down, Peter may start to receive phone calls.
- Other costs may be applicable, such as service charges, leasehold/factor's fees, building insurance costs, costs which are usually paid by the property owner.
- The value of the property may fall.
- The rental amount could fall (if there is a significant increase in the supply of rental properties, this may drive down rental values).

- Unpaid rent may be unrecoverable and/or result in litigation costs.
- There is also an issue regarding Peter's ability to access the funds tied up in the property, especially in a downward market, or periods where potential buyers have difficulty in accessing mortgages. Given Peter's pension was to fund his retirement this may become a major issue.
- Investing more money into property may result in a lack of investment diversification.

On the upside:

- The property may increase in value, which would increase his overall yield when he sells the property (increase in value would only be realised on sale).
- He may get a long-term tenant that pays the rent on time and looks after the property.

Of course, Peter could access the investment potential of property without 'cashing out' his pension.

Self-Invest Personal Pensions (SIPP)

Peter could transfer his AVCs to a SIPP. Within a Self-Invest Personal Pension Plan, most providers permit direct purchase of commercial property, such as offices, retail units and factories.

Commercial property can produce substantial yields. While the risks attached to property values/ rental income/ void periods remain, as the investment stays within the pension the preferential tax treatment of pension investments is preserved, such as exemption from Income Tax, CGT and normally IHT.

The cost of the SIPP will likely be higher than standard personal pension plans, and the trustees will make additional charges for facilitating the direct purchase of commercial property, so this needs to be taken into consideration.

Other indirect property investments are also available to SIPP investors.

Pension Property Funds

Collective investment in property via various pension property funds provides indirect access to many property-based opportunities. Most providers have a property fund and may give access to other provider's funds. These funds can usually be accessed within standard personal pensions, which usually enjoy a lower charging structure than SIPPs. Peter can then sit back and let the fund manager make all the decisions, and because the funds remain within the pension, the preferential tax treatment remains.

Additionally, as there will be professional property managers involved, Peter will not receive a call from tenants to complain about a broken boiler.

These funds will generally be more liquid than direct property investment as you purchase and sell units in the funds. However, as we have seen, depending on the market conditions and outflows of the funds it may be necessary for the fund manager to delay or suspend dealing in the fund.

Potential courses of action

- ☑ Consider wrapper switch
- ☑ Consider further pension contributions, possibly using carry forward
- ☑ Consider changing the shape of remuneration to allow for an employer's pension contribution (covered in more detail in the extracting company profits section of the case study)
- ☑ Consider using salary sacrifice to facilitate an employer contribution

Summary

Peter's holistic financial needs are commonplace; the interaction of all aspects of these requirements need to be taken into account to achieve a truly client-centric solution. The combined skills and knowledge of Financial Advisers and Accountants will be valuable companions on any client's journey.

PRUDENTIAL

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