seeing the whole picture

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Colin Jelley explains why the changes announced in the 2009 Budget will further drive demand for new model planning.

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In the April issue of informer I discussed why changes announced in the Pre-Budget Report relating to the freezing of the pensions Lifetime Allowance highlight the need to review existing long-term savings strategies to ensure that clients are taking advantage of tax efficient financial planning. If the Pre-Budget announcements were not challenging enough, the April Budget and subsequent Finance Bill added the further complexity of a 50% income tax rate from 2010/11 and the removal of higher rate tax relief on pension contributions for those with relevant incomes over £150,000 per annum.

holistic view

Since these announcements there have been reports that pensions, particularly SIPPs, are less attractive now that higher rate tax relief on contributions has been restricted with some saying that offshore bonds might be a replacement product. First, this is too broad a generalisation and, second, focusing on individual product wrappers like this is too restrictive. Assessing tax wrappers in the context of a wider plan is coming to the fore as many advisers are already taking a more holistic approach to financial planning and the Budget changes will simply hasten the transition to this new model of financial advice.

The new model of advice requires standard investment processes for all clients and ongoing reviews to ensure the investment portfolio remains in line with the client's changing requirements. Platforms enable advisers to efficiently identify a client's attitude to risk, match an asset allocation to that attitude to risk and then select multiple tax wrappers to ensure the portfolio is as tax efficient as possible, and that value can be extracted in the most appropriate way for the client. The tax wrapper choice is made in the context of the wider planning context. And as time passes the underlying investment portfolio can then be monitored as a single investment, regardless of the wrappers it is held in, and new investments can be channelled into the appropriate mix of tax wrappers to suit the individual client needs.

combining wrappers

The bond vs. collective argument has been much discussed in recent years but often the choice of wrapper will be decided on issues wider than 18% versus a possible 50% tax rate. The extraction rules for either wrapper differ significantly but either route can offer tax efficient strategies depending on client circumstances.

For many investors, choosing an investment which produces true income yield is likely to mean an increase in their income tax liabilities, especially when incomes exceed £100,000. The marginal rate of tax on income next tax year between £100,000 and £112,950 will be 60% due to the gradual loss of the personal allowance at this level. However if income was sheltered inside a bond, this could offer better returns.

The 5% tax deferred withdrawal from a bond could be attractive if the bond is still retained in retirement. These withdrawals will not be classed as income and will not affect entitlement to any available increase in personal allowances. Unused 5% allowances could be rolled up and used to provide a lump sum to top up any pension shortfall should the lifetime allowance increase in the future or the pension performance be lower than expected. Realising future bond gains in a year when no or only a minimal income is taken for example may significantly reduce the actual amount of tax paid on any realised gain.

The reverse is true for capital growth. With a flat rate of capital gains of 18% and the availability of an annual exemption, the investor could realise significant value from a collective free of capital gains tax, year on year.

tax efficient withdrawals – online tool

Skandia has made a new online tool available to enable advisers to demonstrate how to maximise tax efficient withdrawals from collective investments and investment bonds.

The need to have flexibility in retirement may well mean that one or a combination of these wrappers could be a suitable model to meet varying client needs in the future. Where a combination of wrappers is considered, creating efficient client portfolios is essential. Ensuring that the right mix of income-producing or growth-orientated collectives are held in the right wrapper will further benefit the tax efficiency of any strategy.

the challenge of change

As ever, tax should not be the sole driver of wrapper selection. The new model of financial advice has an investment strategy at its heart with tax wrappers being used to ensure maximum investment returns are achieved from the portfolio. The wrappers selected will depend on the investment strategy chosen, the time horizon of the investment and the expected tax rate of the individual at the time income and gains arise and when value is extracted from the wrapper.

Bonds, onshore and offshore, alongside collectives will have a role to play in conjunction with pensions for investors who may lose some of their higher rate tax relief on pension contributions. I welcome the increase in the ISA allowance (although the transitional complexity is unnecessary) and utilising this and other allowances, such as the capital gains tax annual exemption, will now have greater importance.

This article is based on Skandia's interpretation of the law and HM Revenue & Customs practice as at June 2009. We believe this interpretation to be correct but cannot guarantee it.

The new financial planning tool can show how withdrawals could be made by using a combination of collectives (OEICS/unit trusts) and investment bonds without paying tax for up to three or four decades.

how it works

- The tool combines the use of the 5% tax deferred allowance of bonds alongside the part disposal formula and the capital gains tax (CGT) annual exemption for collective investments.
- Withdrawals can be established which may not be liable to tax for up to three or four decades by investing differing amounts and selecting different levels of withdrawals for each investment.

example

- Consider a £500,000 investment. If the entire amount is invested in a bond and a 5% withdrawal is taken each year, tax is payable in year 21. If the entire amount was invested in a collective and a 5% withdrawal was taken each year, assuming 6% consistent growth, and full CGT exemption available (increased at 2% per annum), tax would be payable in year 11.
- Splitting the investment between a collective (£300,000) and bond (£200,000) and withdrawing £19,000 per annum from the collective and £6,000 per annum from the bond (still withdrawing 5% of the total invested) could extend the point at which tax becomes payable to year 33.

Growth greater than expected on the collective investment may result in CGT being payable earlier than expected but each component of the calculator is variable allowing advisers to make changes to explore how to get the best result for their client.

The new tool is available via Skandia's financial adviser extranet at www.skandia.co.uk

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Calls may be monitored and recorded for training purposes and to avoid misunderstandings.

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