SimplyMoney

The client newsletter of:

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Your independent *window on financial issues* — New Year 2007

In this issue:

- Start the new year with a flourish—if taxes *do* rise how can you protect your income and investments against the worst excesses?
- Funding education costs—we look at an alternative way of helping to provide an income for university students that should keep them out of too much debt.
- Review of 2006—we take a look at the principal features of 2006 and do a little crystal ball gazing for the future.
- Planning to retire in the modern world—we consider the inadequacy of state pension provision and the new rules that will help you "fill the gap".
- Back page briefing—we look at some of the most recent internet scams that are flying through the ether with alarming regularity.

Start the year with a flourish

Government figures reveal that during 2006 we paid tax at a rate of £3 billion a day; and that the total amount of stamp duty, capital gains tax and inheritance tax we pay is rising at a much faster rate than inflation.

Any surprises should not be financial

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Taxes, in the immortal words of the eighteenth century American writer Jeremy Bentham, are inevitable—and government has to be paid for. However, if we consider that the 'headline' figure does not even include an estimated £60 billion each year collected as council tax and corporation tax, it is clear that the tax burden is virtually out of control.

Fortunately, we can take action to minimise the impact of tax on our own incomes and savings by structuring our financial affairs with a little extra care.

For many, the first defence against tax is to make pension contributions. The investments are free of UK taxes (other than the 10% withholding tax on dividends from UK shares—Gordon Brown removed pension funds' ability to recover this many years ago) **and** contributions secure tax relief to a very generous level. Contributions of up to £215,000 (for the tax year 2006/7 and rising thereafter) can be made and will attract tax relief on up to 100% of salary or £3,600 whichever is the greater. Your employer can also top-up your contributions to the annual limit. This will immediately save you income tax. You can also reduce your national insurance contributions by "sacrificing" part of your salary and getting your employer to make a pension contribution instead. (Your employer will also save national insurance contributions.)

Savings and investments are also liable to tax on income generated and capital gains. There is a threshold before capital gains tax applies (£8,800 for 2006/7) and investments held for more than three years win some relief, but even after ten years most asset disposals are taxed on 60% of the gain at the same rate as your income.

One way of protecting your assets against income and capital gains tax is to invest in Individual Savings Accounts (ISAs). As with pensions, ISAs cannot recover the tax deducted from UK dividends, but their growth is otherwise free of UK tax and the money can be paid out at any time as a lump sum or income free of all tax. With a pension, only 25% is currently available free of tax, with the balance being taxed as income. However, the charges associated with an ISA can be higher than if investments are held directly.

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Your home can be a liability, in tax terms

The tax that is rising quickly for many families is inheritance tax. (Stamp duty is even worse, but there is little that can be done to avoid it.) With house prices in the UK rising faster than the miserly annual increase in the inheritance tax threshold (set at £285,000 for 2006/7), more and more families are finding themselves caught by this tax which takes 40 pence in every pound, once the threshold is breached.

Some fairly simple planning can mitigate the impact of inheritance tax, such as making use of lifetime gifts and potentially exempt transfers (PETs) which are gifts made seven years before the death of the donor. Transferring assets between husband and wife (or civil partners) can also make a massive difference to tax liabilities.

Meeting ever rising education costs

It has been estimated that up to 10 million children will fail to benefit from the new Child Trust Funds because they were born "too early". Commentators have suggested that Individual Savings Accounts (ISAs) should be made available to the under 18s (under 16s for Cash ISAs) in order to ensure that they do not have to pay tax on their savings.

Of course, those not liable to tax can use form R85 to apply for gross payment of interest, but where money is invested by a parent on behalf of their child, it is actually treated as the parent's income for tax purposes as soon as the income exceeds £100 a year. For those with an eye to the longer term—particularly university education costs—having savings taxed is simply slowing the rate at which much-needed capital will grow.

R85 allows interest to be paid gross

Even if the government does respond to this suggestion, it will take some time; in the meantime thousands of families will find themselves left behind in the race to help their children meet education costs.

What this brings into focus is that education, particularly at university level, is becoming very expensive. Young people from all but the wealthiest families can be put off by the prospect of graduating with debts that could easily exceed £22,000 if annual tuition fees of £3,000 and living expenses of £4,400 a year are taken into account. This money has to be paid back, even though repayments do not normally start until the graduate's income exceeds £15,000 a year.

Young people are hampered, in building up their own savings, by the 20% tax deducted from most savings accounts (10% on dividends).

There is however a solution, particularly where grandparents are able to make lump sum investments on behalf of grandchildren. If this money is invested in an offshore bond written under trust then, once a grandchild reaches 18 and requires money to cover his or her university education, an income can be drawn from the fund.

5% of the original investment can be withdrawn each year without the application of tax immediately. Instead it is deferred until the bond is encashed or 100% of the original investment has been withdrawn. However, the student is unlikely to be liable to tax as an individual, since his or her income will probably be below the personal allowance.

If for example, £50,000 is invested by a grandparent in an offshore bond and an income of £5,000 a year is taken, £2,500 will be "repayment of capital" and only £2,500 will be taken as income. Even if holiday earnings generate a further £2,500 a year, total taxable income will be less than the current £5,035 personal allowance.

Students have enough to worry about without financial cares as well

To complicate matters even more (but in a positive way) if no money has been drawn previously, then the 5% not taken during each year that the bond exists can be aggregated with the income later on, so that even less of the "income" is potentially taxable. And gains from offshore bonds are "top sliced" for the assessment of tax in any event. This means that the actual gain is divided by the number of years the investment has been in place and then only the result added to the investor's income for the purposes of assessing what, if any, tax rate will apply.

There are, of course, other benefits in this method of transferring money down the generations since, provided it was arranged under trust and the grandparent lives seven years after making the investment, it will itself not attract inheritance tax.

Key points:

- Income generated by parental gifts are subject to tax once income exceeds £100 a year.
- Children born before September 2002 do not qualify for Child Trust Funds.
- Offshore bonds can provide a tax deferred income.

A review of 2006

Writing a review before the end of the year (so that it can be printed in time to go out in early January) inevitably invites events that will make it partially out of date before the ink is dry. There are, however, a number of features of 2006 that stand out and are unlikely to be reversed short of a catastrophe.

Perhaps surprisingly, 2006 has proved to be a good year in so many ways. Despite predictions of a flat housing market and two quarter percent interest rate rises, house prices rose by between 8% and 8.6% during the year to the end of October 2006 (depending on whether you follow the Nationwide or Halifax index).

Rising house prices are something of a mixed blessing. On the one hand, they lead to consumer confidence; on the other, they are potentially inflationary, by leading to demand for higher wages to cover bigger mortgages. From the viewpoint of young people, they are rather less of a good thing, because higher prices make it harder for them to climb onto the housing ladder. This is undoubtedly why one lender has recently announced that it will now lend up to five times earnings. Such lending multiples need not necessarily be a problem so long as house values continue to rise, interest rates are contained and employment levels are sustained.

A strong housing market underpins confidence

Unfortunately there are indications that interest rates could rise by at least a further quarter percent during 2007 and while the number of people in work rose towards the end of 2006, the number of job seekers also increased.

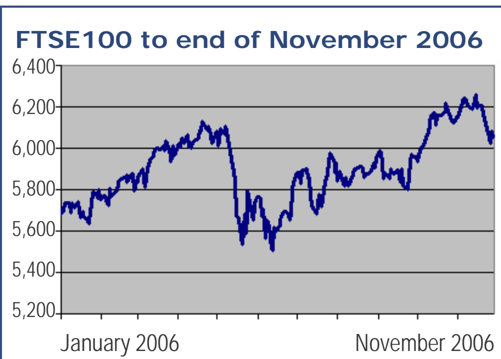
It takes little imagination to see what might happen if house prices cool off in the spring of 2007; negative equity could easily become a reality at the bottom end of the market and this would hit the entire property ladder. While it is important to help people to buy their first property, lending massive salary multiples could be the wrong thing to do. More affordable housing is one solution; shared ownership could be another.

One good sign during the latter part of the year has been a fall in the cost of crude oil. This was forced up early in the year by a number of factors including fears over an escalation of trouble in the Middle East, as well as some well publicised structural problems such as major oil refinery fires and increasing demand from the emerging economies of the far east. A classic example of what economists like to call demand-pull and cost-push inflation.

Fortunately, some element of geopolitical stability appears to have returned and Brent Crude 1-month ended November at US$64.26 per barrel after having peaked at US$78 per barrel in July when the Israeli-Lebanon crisis was at its height. The price at the start of the year was US$58.98, so prices are 8.95% higher; unfortunately, the trend appears to be upwards, but there are so many factors influencing oil prices that it could be "all change" by the time you read this.

Equity markets are critically important to almost everyone, even if they do not own shares directly. This is because pension funds hold a high proportion of our money in this medium. It is therefore pleasing to note that this has been a good year.

At the end of November, the FTSE100 stood 7.65% higher than at the start of the year. During the past three years, December has produced an average growth of 2.7% over November, although the trend has been rising, so we could possibly anticipate a year-end level of between 6,200 and 6,300, which would represent an annual growth in the range 10% to 12%. Growth for the FTSE250, which includes companies with smaller market values, has already topped 21% for the year and there is no reason to think that it will fare less well during December.



The main US indices also performed relatively strongly throughout the first eleven months of 2006, although in their case falling US Dollar values could impact on markets by the end of the year. The main Japanese index showed little growth during the same period.

Of greater concern is the question of *where* economic growth will come from next year. During the past decade, growth has been underpinned by cheap labour and rapid development within India, China and the other "tiger" economies. This is unlikely to be sustained in the long term as consumerism in those territories leads to increased demand for higher wages, cutting the cheap markets we currently buy from. Conversely, more expensive imports tend to support domestic markets, so it is by no means all doom and gloom.

Planning to retire in the modern world

The world of individual and company pension provision changed in April 2006—largely for the better. Which is just as well, because state provision is hardly adequate to provide an acceptable level of retirement income.

To put this into context, the basic state pension for a single person is currently £84.25 a week. National average pay stood at £8.28 per hour in mid 2006 (Source: www.statistics.gov.uk), so the state pension was then worth the work of just over ten hours a week—and that is for average pay, not the higher levels that most of our clients will be achieving.

The "best" occupational schemes target a pension equivalent to two thirds of final salary. So at the very least, on this reckoning, the target retirement income for someone on the average hourly rate working a full 40 hour week should be in the region of £220 a week—not £84.25!

State pensions may no longer be paid at Post Office counters, but they are no more valuable than when they were

To make matters worse, state pensions rise in line with the retail prices index (RPI), which almost always lags behind the increase in national average earnings. This means that pensioners become progressively worse off, compared with those in work. The government has indicated that it intends restoring the link to earnings in 2012; but for many this is too little, too late as it does nothing to redress the shortfall that has accumulated since the link was broken by Margaret Thatcher's first administration in 1980. If that isn't enough, anyone currently under age 47 is likely to have to wait a little longer before they can expect their state pension in any event, with state pension age expected to reach 68 by 2046, following publication of the Pensions Bill.

The majority of people today are probably in what are called 'defined contribution' or 'money purchase' schemes, either personal pensions, group personal pensions or occupational schemes. This means that their pension is calculated not on an earnings-based 'guarantee' provided by their employer, but the amount of money invested, plus investment growth, less expenses. Unfortunately poor investment returns during the early part of this decade have been compounded by Gordon Brown's infamous £5 billion a year raid on pensions, when he removed the ability of pension schemes to recover the tax deducted at source from dividends of UK companies. As a result most of us will need to think very hard about how we provide for our retirement.

For once, changes have been helpful

This is where the good news comes in. As we mentioned at the start of this article, the rules relating to pensions

have recently changed and this means that you can almost certainly contribute more into your pension now than you could have done last year. In fact, prior to April 2006 you could normally only invest from 17.5% to 40% of your income (depending on age) each year. This was subject to an 'earnings cap' which was £205,600 in its final year (2005/6) making the maximum contribution for someone under 35, £35,980 and for an 'over 60', £42,240.

Employers can also contribute for employees

Under the new rules, contributions of up to £215,000 (for the tax year 2006/7 and rising thereafter) can be made and will attract tax relief on up to 100% of salary or £3,600 whichever is the greater. What is more, once your contributions have reached your actual earnings, an employer can "top them up" to the annual allowance, provided that the total remuneration package can be justified to the local Inspector of Taxes as a legitimate business expense. They will want to be reassured that the total expenditure is for the benefit of the business, not the taxpayer.

Contributions in excess of the annual allowance will be subject to 40% tax.

One of the other major changes is that contributions can be made into a personal pension at the same time as to an occupational scheme, even for those earning more than £30,000 a year. And you can even start to "crystallise" your pension benefits by drawing a cash lump sum (currently free of tax) of up to 25% of the fund while still working, without actually drawing an income or buying an annuity, thanks to a new version of "drawdown" called unsecured income.

The earliest age at which benefits can be drawn remains at 50 until April 2010, when it rises to age 55. It is important to be aware that there is also a lifetime allowance above which pension funds must not grow, or there will be a lifetime allowance charge of 55% of the excess. The allowance is, however, generous at £1.5 million (for 2006/7 and increasing thereafter) which the government has equated to a nominal pension of £75,000 a year at age 65.

Investing for retirement is a long term strategy for most people and one that needs careful consideration. It is important to look at the issue of asset allocation strategies across your entire investment portfolio, because pensions are simply a tax-efficient part of your strategy. In general, the longer you have to go before retirement, the more "risk" you can accept. The shorter the time to go, the more stability—and lower costs—you are likely to demand.

Key points:

- State pensions, even with the addition of graduated pensions, SERPS and the state second pension will be inadequate for most people.
- Personal provision is essential—and it has just become a lot easier.

Happy New Year.

Back page briefing—avoiding the growing number of scams

We make no apology for re-visiting the topic of internet fraud; this is, after all, a scourge of modern society that can affect any of us.

As we become increasingly dependent on computers, we are more and more exposed to criminals who are seeking to make money out of us.

It started with allegedly innocent viruses which were little more than an inconvenience—although businesses caught by them could lose significant amounts of money in terms of costs, downtime and lost revenue.

But (while these are still about) it seems that this was simply a prelude to more sinister attempts directly to part us from our money, both through identity theft and direct fraud.

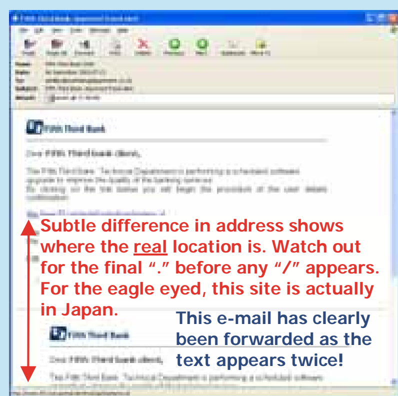
Identity theft can result from hackers gaining access to our computers while we are online (as many of us are for increasing lengths of time, courtesy of broadband). They use various techniques to read what we are typing, or simply trying to gain personal information from files on our hard drives. This can be used to access on-line bank accounts and even to reproduce credit card details.

"Phishing" is the use of fake e-mails, ostensibly from a bank, asking the recipient to complete a re-registration process because of an alleged breach of security at the bank. Some of these even say that you should beware of scams!

It is a bit of a giveaway when you do not even have an account with the bank concerned, but "spotting the rogue" can be more difficult if the e-mail appears to come from your own bank.

There is an absolute failsafe—in addition to looking to see what the real web address behind the link is *(hovering over the link will show the actual address at the bottom left of the message in most e-mail programmes)*—and that is not to respond or follow the link provided. Your bank will **never** approach you in this way under any circumstances.

Some direct fraud attempts are laughably



transparent, others seek to appeal to our "baser" natures.

Our favourites are those which offer you a share in millions of dollars simply for making your bank account available as a laundering facility for "unallocated" money.

The word laundering is used advisedly, because there is almost always a criminal element to the proposal, which will seek to appeal to the reader's desire to "get something for nothing". There is no such thing as a free lunch.

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