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Call us on
0116 2592371
or email:
info@providentsolutions.co.uk
www.providentsolutions.co.uk

Provident Money

Your **independent *window on financial issues*** **April 2005**

"Steady as she goes" is the word

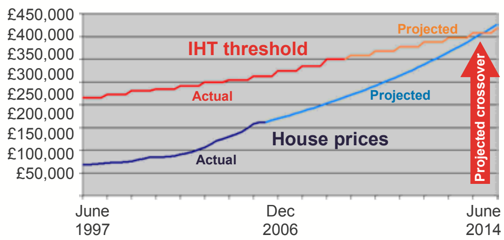
OK, "Steady as she goes" is a phrase not a word, but when steering the ship of state, Gordon Brown has clearly decided not to stage a pre-election give away—for which he is probably to be congratulated, even if we did only hear about "Prudence" once.

As has become common in recent years, rumours of a potentially devastating blow, in this case the application of Capital Gains Tax to primary residences, failed to materialise thus taking attention away from other, less palatable, changes.

One of the major changes that did not take place was a significant increase in the level at which Inheritance Tax starts to bite. In announcing that this will increase to £300,000 by 2007/8, the Chancellor failed to mention that this year's increase is a miserly 4.5% - more than inflation, but less than the rate of increase in house prices, over the past twelve months, which the Halifax's latest figures (February 2005) show as being 12.1%. As a result, it is still likely that the average UK house price will outpace increases in the IHT threshold within just a few years. In many parts of the country—particularly some 'hotspots' within London and the South East—this is already the case.

One good piece of news, which will help the housing market, is that Stamp Duty Land Tax (what we used to call Stamp Duty) will no longer start until transactions of £120,000—double the current limit. This will help first time buyers and thus unblock a perceived 'log-jam' at the bottom end of the property market. It is also likely to help the economy, as consumer confidence is bolstered by a more positive housing market. This could, however, in turn, lead to a medium-term rise in interest rates, if the Bank of England's Monetary Policy Committee considers the economy might otherwise overheat.

Inheritance tax vs. Average house prices



Source: HBoS for historic house prices
Future projections: 2.25% a quarter for house prices; and 2.5% each year for IHT threshold, after expiry of figures announced in Budget.

Another apparently positive point is that the Chancellor announced the permanent abolition of hospital charges within the NHS. At first glance, this could be taken as an indication that the need for Long Term Care will be reduced. However, since most LTC is provided within the private sector, it is unlikely that there will be any significant impact, which means that those with above a minimal level of assets—including their own home—who need full time nursing care, will still have to find substantial sums of money to cover the cost.

An election budget from the Chancellor?

Set against this, pensioners can expect not just the £200 winter fuel allowance (£300 for the over 80s) this autumn, but a £200 refund against their Council Tax charge, as well.

Most worrying of all, is that the household savings ratio is now just 5.6% and while this is higher than the US and Canada, it is substantially below the 9.9% figure, when this government came to office in 1997.

Extending the current Individual Savings Account limits for a further five tax years is most welcome; but nothing has been done to redress the massive shortfall in retirement planning. Reinstating the Tax reclaim on both pensions and ISAs might well have been a helpful gesture to redress this.

Tax efficient savings

Research commissioned for the Association of British Insurers, conducted by Oliver Wyman and Co, and published in September 2001, identified a £27billion-a-year gap between what we are *currently* saving towards retirement and what we *need* to save, to achieve an adequate income in retirement.

For most people, conventional pension plans will be the starting point for retirement planning. There are good reasons for this, not least that they attract tax relief on contributions, are largely free of tax while growing and up to a quarter of the plan can be taken as **tax free cash** on retirement. What's more, employers can make contributions as well—without generating a benefit in kind tax charge and securing full tax relief on the contributions themselves.

Source: ABI news release 3/10/2001

Importantly, almost everyone in the UK can have a personal pension—even if they have no income—based on contributions of up to £3,600 a year (less tax relief at the basic rate—*even if they don't pay tax*). Those with income can invest anything from 17.5% of their income to 40%, depending on age, in a personal pension. (Members of company schemes can invest up to 15% of their income on top of whatever their employer puts in.)

What's more some of those currently excluded from personal pensions (such as members of company pension schemes who are directors, or earn more than £30,000 a year) will also be able to have a personal pension from April 2006.

The downside to pensions is that once the **tax free cash** has been taken, the remaining fund must be taken as a taxable income. As a result, many people will additionally consider the use of ISAs, as part of their retirement planning.

Although ISAs do not attract tax relief on investment, they do grow in a similar tax-free environment to pensions and lump sums, or an income, can be taken at any time without any tax liability whatsoever. As we have recently reported, the current annual contribution limit of £7,000 per person looks likely to be extended to April 2009 split between up to £1,000 in life assurance, up to £3,000 in cash and the balance in equities.


We need more than a clock to retire on

This means that almost everyone can invest nearly £10,000 (net of tax relief) towards his or her retirement every year.

In addition to ISAs and pensions, it is worth noting that some forms of National Savings are also tax free, including Premium Bonds and several of the Fixed Interest Savings Certificate issues, which currently (Source: National Savings 1/2/05) pay anything from 'inflation plus 0.95%' to 4.45% p.a. for the TESSA-only ISA.

Offshore Bonds are only tax-free while the money is held outside the UK. However while they are, they grow totally free of tax and can thus 'roll up' gross, offering massive investment potential. Normally equity based, they can offer risk diversification and switching between different asset classes. They do, however, carry higher charges than equivalent UK funds and encashing the bonds will attract tax at the investor's marginal rate—so the entire growth could be subjected to 40% tax.

These investments can be useful in deferring tax, rather than avoiding it, and using an offshore bond to gift money to a non-taxpayer—such as a student, to cover university living expenses—can be particularly beneficial, as they can draw an income from the bond without actually paying tax, provided that they do not breach the personal allowance (£4,895 for 2005/6 (Source: Pre-Budget Statement news release PN2 2/12/04).

For those willing to accept a far higher risk profile, Venture Capital Trusts offer a highly tax efficient form of investment, with (currently) tax relief at 40% on the investment up to (currently) £200,000. There are different forms of VCTs investing in the shares of unquoted trading companies that might be listed on AIM, in specialist sectors, or of a more general nature.


VCTs come in different forms with different objectives

The principal benefits of VCTs are that they are free from Capital Gains Tax and, just as important, dividends are also free of income tax (unlike normal shares which are subject to the 10% withholding tax and possible higher rate tax charges). There is also a potential exemption from Inheritance Tax.

Although inherently high risk, these tax advantages may limit the downside potential. (The level and bases of, and reliefs from, taxation are those currently applying or proposed and are subject to change.)

Enterprise Investment Schemes also benefit from similar tax benefits, but are generally considered to be a far higher risk, since they do not involve the same spread of investment as VCTs.

Before considering the tax efficiency of any investment, its risk and possible return profile—as well as charges—should be considered in the light of your own priorities. After all, freedom from tax is of little value if you lose your money by taking unacceptable risks.

The value of investments can go down as well as up and you may not get back the full amount invested.

Key points:

- Pensions are a good starting point, but have limitations;
- Other forms of investment can also be highly tax efficient;
- Overall return, net of charges, is as important as anything;
- Outline of VCTs in ***Back page briefing***.

Are 'offset mortgages' for everyone?

Turning down interest on your savings might sound like financial madness. But those with mortgages might like to think about going down this route.

Long ago, mortgage interest attracted tax relief; but those days are sadly gone, with MIRAS relief largely disappearing in April 2000, except for those aged 65 plus, who took out loans before 1999 to purchase a life annuity.

On the other hand, income from savings is taxed at 20%, so the interest you actually receive is worth less than the headline rate. What's more, the interest rate you pay on your mortgage is usually higher than that you receive from most interest bearing accounts.

So you are probably paying a lot more on money you borrow, than you are receiving net on money you save.

But while it may therefore appear sensible to use every penny you have to reduce your mortgage, everyone needs a cash reserve—to pay for unexpected expenses, or to plan for a holiday. So what is the solution; how can you minimise your mortgage repayments, while still having immediate access to your cash?

The 'offset' mortgage could well be one answer because they allow you to keep money in both savings and deposit accounts within the same overall arrangement. This gives you access to your cash, but can save money on your mortgage, making it much easier to repay the loan earlier, if you wish to.

Your savings could help cut the cost of your mortgage

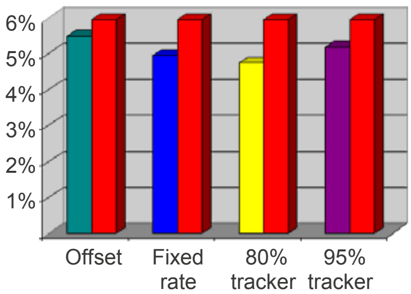
How they work. Offset mortgages look at your current and savings accounts, each day, and deduct the total from your mortgage ***before*** interest is calculated. Naturally, this means you don't receive interest on your savings, but you pay mortgage interest on a lower balance.

What's more, you can set your repayment level at a higher amount than the amount actually needed to cover interest and capital, each month. By doing so, your mortgage balance will reduce much faster than if you paid the 'right' amount.

Of course, with an arrangement of this sort, there can be additional benefits from managing the timing of your payments, because the longer you keep money in your current account, the more it reduces the interest you have to pay on your mortgage—because of the daily calculation of interest. So altering your buying habits to make sure that as much as possible is purchased on your credit card—and then clearing the card completely, as late as possible without incurring a penalty or interest charge—can be a real bonus. Even having your salary paid directly into your bank account, rather than by cheque, can give you a few extra days when the interest is charged on a lower mortgage balance, having been offset against cleared funds in your current account earlier.

Some schemes can even include your credit card and overdrafts.

But offset is not suitable for everyone. To work properly, you need to be able to maintain a credit balance in your current account and must have some savings.



Left columns are introductory rates, right columns are rate after 2 years offer period. APR 6.0% to 6.1%

Source: Intelligent Finance February 2005

And you may well find that you are paying a higher interest rate than were you to choose some of the alternatives, particularly those with special offers.

Typically interest rates on 'offset' mortgages are higher than those of 'discounted rate' or 'tracker' mortgages. If you would like to acertain whether an 'offset' mortgage may be suitable for you please contact us for further details and advice.

Your home may be repossessed if you do not keep up repayments on your mortgage.

Key points:

- Conventional mortgages can offer good value;
- Offset mortgages balance savings and borrowings to keep costs down;
- Offset rates can be higher, or special offers less generous;
- Offset mortgages can have lower fees and fewer penalties.

Have you made a will—is it up to date?

Even those who do *not* subscribe to the view that writing a will makes it more likely you will die can be a little 'relaxed' about their efforts to keep things up-to-date. Yet the implications of getting it wrong can be far-reaching.

Intestacy rules in the UK are complex, to say the least, but can easily result in those whom we wish to receive our money being left out and others, whom we might not wish to benefit, receiving a substantial amount of our money. For example, unmarried couples (whether 'same sex' or not) cannot currently inherit from each other unless there is a will.

Death comes to us all; and it helps to have our financial affairs in order

This means that the death of one partner may create serious financial problems for the remaining partner—particularly if they own a home together.

And, of course, without the advanced planning involved in preparing a will, it is difficult to ensure that IHT exposure is adequately limited.

Planning your will is particularly important if you live outside the United Kingdom—or you live here but you own an overseas property, such as a holiday home, as inheritance rules overseas can be very different. Similarly, those who own businesses need to consider carefully how shares are to be disposed on their death, although this might be provided for in a partnership deed or articles of association.

In order for a will to be valid, the testator must be:

- 18 years old or over and of sound mind; and
- making the will voluntarily and without pressure from any other person.

Wills must be in writing and signed by the person making the will in the presence of two witnesses, who must also sign it.

When a will has been made, it is important to keep it up to date to take account of changes in circumstances, to ensure that it continues to reflect your wishes.

Events that might initiate the need for a change could include getting married, divorced or separated, or the birth / adoption of children, if they are to be added as beneficiaries under the will. Wills can, of course be changed by making a codicil to an existing one or by making a new will. For assistance with making a will, please contact us.

Enduring power of attorney

An enduring power of attorney gives an 'attorney' (who can be almost anyone other than a bankrupt) the ability to manage the 'donor's' affairs.

Even those with their full faculties now can suffer later

An *ordinary* power of attorney—which can relate to all the individual's affairs or only to specific matters—can be granted for a finite period. But where the person concerned has been diagnosed with (or may develop) a mental illness, an *enduring* power of attorney can give someone the ability to act on their behalf immediately, or in the future.

A donor can appoint more than one attorney, which has the advantage that fraud or improper acts by one attorney are less likely. If attorneys are appointed as 'joint and several' attorneys, they may either act together or individually, and the power of attorney will continue in force if anything happens to one of the attorneys. The signature or action of one attorney is as valid as if they were the sole attorney.

Attorneys are in a position of trust and must act in the best interests of the donor, using their money to meet the donor's best interests and act only within the authority granted, keeping separate up-to-date accounts of the donor's affairs.

An enduring power of attorney must be created in a set format and professional advice should always be sought before any decisions are made. More than one enduring power of attorney can be made, appointing different attorneys to do different things.

A power can be set up so that it does not come into effect unless the donor becomes mentally incapacitated, and the attorney can be required to produce medical evidence from one or more doctors before the power comes into effect.

Key points:

- Making a will is an essential part of financial planning;
- Thinking about what happens if you should later become mentally incapacitated makes good sense;
- If asked to act as an attorney, consider the responsibilities carefully.

Back page briefing—VCTs

VCTs were launched in 1995, to give individual investors the opportunity to invest in newer companies. This helps the companies to generate substantial growth by accessing external capital, as it is more worthwhile for investors to make a long term commitment. Since launch, £1.5 billion has been invested.

These are **not** direct investments in companies, but collective investments managed by specialist managers. Funds can be invested in private companies as well as unquoted, OFEX and AIM listed companies. This approach can offer investors the chance to spread their money round a range of ventures, rather than putting all their eggs in one basket.

Smaller companies can often produce far greater growth potential than more established ones, because they have the ability to react more quickly to new opportunities than their more established competitors and thereby provide better investment returns. From the government's point of view, encouraging new companies offers the potential for greater job creation, which is generally good for the economy—provided it does not make labour a scarce resource; which can lead to wage inflation. As ever, in economics, each benefit carries with it the corresponding downside.

The greater risk of failure makes the role of the specialist manager so important, as they can undertake the research necessary to reduce potential risk. Of course, many VCT managers now have a track record which can help investors select the 'right' investment for them.

Managers can take their time considering ventures to invest in, as they have up to three years to move out of cash. This is useful to the individual investor, as success in any business is a combination of the right ***idea***, the right ***business*** and the right ***team*** to achieve the vision. Successful VCT managers are good at spotting likely successes, but need time.

In general there are three types of VCT:

- **General VCTs** can have a variety of formats. Some are constructed to finance management buyouts; where the trust helps the existing management to gain control of the company by buying out the existing shareholders. Others are established to provide development capital for existing companies which might be used for expansion or acquisition. A third type provides seed capital to help those with worthwhile new ideas to get started. In general, these will have more than just a good idea, and may have well developed business plans and systems specifications (usually protected by copyright or patent laws) that give something substantial that the investors receive, in return for their money.
- AIM VCTs concentrate on helping companies to come to market through the Alternative Investment Market, or to develop once they have achieved that status. One of the principal benefits to those investing in this sort of VCT is that the companies will already have a track record and market presence. The cash injection will often give management the opportunity to grow the business substantially, while imposing a financial discipline that might previously have been less significant.
- Specialist VCTs concentrate on particular business sectors, such as engineering, new technologies or alternative energy sources. They will achieve risk spread by investing in various companies in different stages of development, so that some will be complete start-ups, as with the seed capital VCT, whereas others might already be listed on AIM.

The greater the potential for reward, the greater the risk. VCTs, almost by definition, include investments in underlying companies with a limited track record—or none at all. There is therefore an increased risk that investments in VCTs will produce negative results.

The value of investments can go down as well as up and you may not get back the full amount invested. The past is not a guide to future performance and past performance may not be repeated.