

KENNEDY BLACK

WEALTH MANAGEMENT

QUARTERLY PRIVATE CLIENT NEWSLETTER

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Welcome to the latest Kennedy Black Private Client Newsletter, the first of 2011.

With the end of the tax year approaching, I have attempted here to outline some prudent steps to be thinking about in advance of April. I try to illustrate why ISAs are almost as good as pensions when it comes to tax efficiency, even in spite of the fact that there is no tax relief on contributions. Furthermore, investors should be thinking about reducing their CGT exposure through some simple steps.

Finally, I conclude with some more general thoughts investing for children, a popular topic with our clients at the moment.

PENSION VS ISA

Every week, The Sunday Times 'Money' section interviews a celebrity about their finances, and one regular question is "do you prefer pensions or property?" I'm always pleasantly surprised (as happened this week) when someone picks pensions, particularly given the bad press they tend to receive.

The mere question itself (in this property-obsessed nation) suggests that pensions are a well-recognised and popular vehicle.

What might surprise most people is that an ISA is almost as tax efficient as a pension, in spite of the fact that ISA contributions do not attract income tax relief (which is perhaps the biggest attraction of a pension).

An often misunderstood fact surrounding pensions, particularly for those with a long time to go until retirement who rarely think about these things, is that the income you take from your pension in retirement is not tax-free. The first 25% can be taken as a tax-free lump sum but the remaining 75% must be taken as income, and that income tax is subject to the same income tax rules as pre-retirement income.

While an ISA does not attract the immediate benefit of tax relief on contributions, it does have a sting in the tail since income can be taken completely free of income tax.

To summarise the maths very quickly: if you are a 40% taxpayer and contribute £60 to a pension, HMRC will make it up to £100. Let's say it grows tax-free at 7% pa and is worth £542 after 25 years. An income yield of 5% would generate an income of £27 a year, which if you are a 40% taxpayer in retirement would be £16 net.

The same 40% taxpayer pays £60 into an ISA, which also grows tax-free at 7% a year and is worth £325 after 25 years. An income yield of 5% would generate an income of £16 a year *tax-free*. This is the exact same income as from the pension.

So at its most straightforward, a pension and ISA look quite comparable.

However, there are a couple of points that sway it back in the favour of the pension. Firstly, we have ignored that the first 25% of a pension is a tax-free lump sum. That's a big incentive, although there's no guarantee that will still be the case by the time you reach retirement.

Secondly, if you are a higher rate (or additional rate) taxpayer now and expect to pay a lower rate of tax in retirement, then there is a clear benefit in getting higher rate tax relief now only to pay a lower rate when you take the income.

So, yes, pensions still rule the roost when it comes to tax efficiency. However, the difference is rather more subtle than most appreciate. And like the question in the Sunday Times, the mere fact that we are comparing ISAs to pensions should demonstrate that ISAs are a valuable tool.

CAPITAL GAINS TAX PLANNING

As well as ISA planning before the end of the tax year, another form of effective tax planning revolves around managing capital gains.

This is particularly important for higher and additional rate (50%) taxpayers, since it is clearly much better to pay CGT at 28% than income tax at 40 or 50%. Furthermore, everyone is entitled to a £10,100 exemption from CGT every year. Hence, with some careful management, you need not pay any CGT at all.

Kennedy Black Wealth Management Ltd • 10 Nelson Terrace • London • N1 8DG
Tel: (020) 7125 0224 • email: enquiries@kennedyblack.com • web: www.kennedyblack.com

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The important point to note is that Capital Gains Tax is only payable in the year in which the gain is crystallised. Hence, on a portfolio of shares or funds, it is relatively easy to ensure that no gain is crystallised in excess of the £10,100 exemption. Yet you cannot carry forward the exemption, so much like the ISA allowance it is a use-it-or-lose-it exemption.

It is perhaps harder to manage gains from, for example, the sale of an investment property since the gains may be greater and it isn't possible to realise part of the gain now and part later. However, with shares and other unit-based investments, it is.

INVESTING FOR CHILDREN

A popular topic with clients of Kennedy Black Wealth Management is how to save for their children. With the recent withdrawal of the Child Trust Fund and no sign yet of the promised "Junior ISA", are there effective ways to save for children?

The first important decision to make is to decide what you are actually saving for. Are you saving a pot of money that little Johnny will acquire on his eighteenth birthday to spend on whatever he sees fit, or are you including things such as school and university fees as well?

The second decision to make is how much you would like to contribute. The old Child Trust Funds used to allow £1200 per annum, or £100 a month. This may not sound like much, but over an 18 year period that could end up being worth over £27,000 in today's money (assuming growth of 3% over inflation and 1.5% annual costs). That's a relatively sizeable sum for an 18 year old.

The Junior ISA (expected to be launched later this year) is rumoured to be very similar to the old Child Trust Fund although without the Government's contribution (which was originally up to £500 a child).

If you wish to save more, however, some caution is advised. While children get their own tax allowances for income tax and CGT, any income in excess of £100 per year that comes from an investment that a parent has given to a child is deemed to be income of the parent – hence subject to the parent's rate of income tax.

However, this does not apply to, for example, gifts from grandparents. Nor are capital gains subject to the same constraint. Hence CGT planning is a good idea, as outlined in the previous section.

Furthermore, it would be advantageous to write the investments under a trust with the child named as beneficiary. That means that there is a clean separation of ownership from the parents, but at the same time giving the parents (in their capacity as trustees) the ability to manage the assets for the benefit of the child. That could include paying for school and university fees.

However, it is likely that such arrangements will not be sufficient to pay for school fees, if you are indeed planning to send your children to an independent school. With some schools now costing up to £10,000 a term, school fee planning is a separate topic in its own right.

Without wanting to alarm our readers, sending a child to a top independent school for their entire school career is likely to cost over £600,000 per child (assuming fee inflation of 5% pa). To afford this, a lump sum of £270,000 could be made now, or

alternatively a monthly savings plan could be put in place starting at £2,500 a month, although this would decline once they start school. Both are clearly considerable commitments.

INVESTMENT RULE #5:

"Review your portfolio regularly"

When you first invest, you take time to consider your position and set up a properly diversified portfolio to meet both your risk profile and objectives. You may even make some assumptions (e.g. about school fees – see previous section). The idea is you can then sit back and give it the time it needs to grow.

This is indeed the whole point of planning. However, over time, your needs and circumstances can change – and your assumptions, particularly about performance, may not pan out exactly. Rather than forget your portfolio completely, we believe that an annual check-up is an extremely valuable exercise.

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