Safehands Independent Financial Advisers Ltd.

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Finding income: a tricky savings climate

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Does pension beat property?

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Residential property beats pensions as an investment for retirement planning, according to the Bank of England's Chief Economist. But is he right?

Andy Haldane grabbed a few headlines recently when in an interview with the *Sunday Times* he suggested his favoured investment for retirement savings was residential property. It is a view many people with a less profound understanding of economics would share, as evidenced by the popularity of buy-to-let property as an investment.

Mr Haldane's main justification for choosing property was that in the UK demand has consistently outstripped supply, which to an economist means prices can react only one way – "relentlessly heading north".

In practice, residential property prices have not always increased. The market is cyclical – like most markets – and if you invest at the top of the cycle (e.g. the third quarter of 2007) you can wait a long while (e.g. until the second quarter 2014) before you see any capital growth, even if you ignore expenses.

Moreover, the government is intent on raising those expenses: the list includes an additional 3% across each band of stamp duty land tax (land and buildings transaction tax in Scotland) for all second homes including buy-to-let properties, a phasing out of higher rate mortgage interest relief, a less generous allowance for replacement of furnishings and a higher rate of capital gains tax than applies to other asset classes.

But the best reason for not increasing the weighting of property at the expense of other asset types as part of your retirement planning was recently given in a speech by one of Mr Haldane's former colleagues at the Bank of England, Andrew Bailey. He was once a Deputy Governor and is now the Chief Executive of the Financial Conduct Authority.

Shortly after Mr Haldane's interview appeared, Mr Bailey gave a speech in which he looked at "the two big investments in the life cycle model – a home and pensions". He said that the main problem with buying residential property instead of a pension was the lack of investment diversification. In other words, owning your own home probably gives you enough exposure to the residential property market, not just in terms of asset value but also in terms of the amount of money you invest in your own dwelling over a lifetime. In any event, it is important to take individual advice based on your own particular situation.

The value of your investment can go down as well as up and you may not get back the full amount you invested. Past performance is not a reliable indicator of future performance. Investing in shares should be regarded as long-term investment and should fit in with your overall attitude to risk and financial circumstances. Buy-to-let mortgages are not regulated by the Financial Conduct Authority.

LISA reappears after a summer redesign

The Lifetime ISA is back in the spotlight, with a detailed framework published in early Autumn.

In what proved to be his final Budget, George Osborne announced the launch a Lifetime ISA from April 2017. The LISA, as it was labelled by all except the government, was widely seen as a stalking horse for future pension reforms. Mr Osborne had been expected to announce changes to tax relief on pension contributions last spring and it remains possible that his successor, Philip Hammond, will do so in the Autumn Statement on 23 November 2016.

When Mr Hammond replaced Mr Osborne in July, it was far from clear that the LISA would survive the change of occupant at 11 Downing Street. The original LISA proposals had been subject to much criticism for their potential complexity and the launch timescale. It was therefore a surprise when the government introduced the Savings (Government Contributions) Bill in early September, setting out a broad LISA framework. The Bill was accompanied by an "updated design note" for the LISA, which revealed several changes to Mr Osborne's March proposals, but left the basic structure intact:

- You will only be able to start a LISA if you are aged between 18 and 40. The logic is to encourage saving amongst the young;
- The maximum LISA contribution will be £4,000 per tax year, which will count towards the new overall ISA contribution limit for 2017/18 of £20,000;
- Any LISA contributions made before age 50 will attract a 25% government bonus, meaning that for the maximum contribution of £4,000 a £1,000 bonus will be added;
- The range of eligible LISA investments will be the same as for the current cash and stocks and shares ISAs. LISAs will enjoy the same tax advantages, meaning returns will be free of UK income and capital gains tax;
- All or part of the value built up in a LISA can be withdrawn penalty-free from age 60 onwards or for the purchase of a first home worth up to £450,000; but
- Any other withdrawals will normally attract a 25% penalty, designed both to clawback the government bonus and to discourage early encashment. If you withdraw £5,000 whilst you are under age 60 and not buying your first home, £1,250 will disappear.

The 25% government bonus has the same effect as giving 20% tax relief, but there is an argument that it is more easily understood than the tax relief for pension contributions which is often poorly understood. Unlike pension tax relief, the government bonus is the same for all taxpayers, making it akin to the flat rate pension tax relief that many expected would arrive in last March's Budget.

There has been some debate about whether a LISA contribution makes more sense than a pension contribution (under current rules). If you are in the position to choose between the two next April, then personal advice based on your own particular situation is essential. While a LISA and a pension have the same tax benefits during the investment period, at the stages of making contributions or drawing benefits, tax rules are distinctly different.

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Finding income in a tricky savings climate

Real interest rates may not rise much above 1% – even in the longer term according to the Bank of England. If the Bank is right about this, where can investors find income now?

The Bank of England asked two key questions last December – first: how far have 'real' interest rates (that's after allowing for erosion by inflation) fallen globally? Second: how likely are they to stay at their current low levels?

What are the implications?

The Bank argued that the fall in real interest rates over the last 30 years was driven by a mix of changes including population aging and increased levels of saving especially in emerging markets. They thought these trends would persist for some time and didn't see interest rates rising much for some time either.

If the Bank turns out to be right, what are the implications for people who need income from their investments – especially those in retirement?

Both cash and fixed interest securities look unpromising at the moment – yields are at or near all time lows. That doesn't mean that there is no place for holding cash and bonds as part of a diversified investment portfolio. But it does mean that investors should be looking for income from shares and property as well.

Dividends from equities (company shares) have traditionally provided the answer for investors wanting a reasonably dependable income. This involves them giving up some of the capital security provided by cash deposits and some fixed interest securities. The value of their capital in shares can go down as well as up, and the dividends aren't guaranteed.

But with equities there is also the prospect of some possible long-term capital growth. And that can be very important in boosting investment returns over the years. The difference between income and capital growth is that the income is usually reasonably regular, while any capital gains tend to come in spurts – with years of no gain or even losses followed by sharp up turns.

“The Bank of England specialists expect interest rates to stay lower for longer; that will mean investors changing their investment strategy to meet these unprecedented conditions.”

Diversifying your investment portfolio

Most people cannot just live on the income from their investments; it is necessary to draw on capital gains as well as living on total returns from their investments.

That means having a diversified investment portfolio. Part could be invested in equities to provide both income and (hopefully) long-term capital growth. But some of the portfolio should be in cash and fixed interest securities to help smooth out returns and to provide a reserve of very safe investments to draw on in turbulent times. The total returns you get from such a portfolio should provide a sustainable stream of spendable income. The Bank of England specialists expect interest rates to stay lower for longer; that will mean investors changing their investment strategy to meet these unprecedented conditions.

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Salary sacrifice rules to be tightened

If your employer allows you to exchange salary for benefits, such as a mobile phone or a company car, you may be paying more tax from 2017/18. HMRC is consulting on a revised treatment for salary sacrifice arrangements. The proposals are that income tax and employer’s NICs should be levied on the greater of the salary forgone and the taxable value of the benefit (which might be nil). Fortunately, pension contributions made by salary sacrifice will be exempted from the new rules. The value of tax reliefs depends on your individual circumstances. Tax laws can change. The Financial Conduct Authority does not regulate tax advice.

Is your family financially protected?

The existing system of bereavement benefits is being overhauled from April 2017. A key change will be the end of widowed parent's allowance which is currently paid until the youngest child leaves education, to be replaced by just one year's payments for new claimants. What would happen if your family was affected?

Reviewing life insurance provision is even more important than making sure you are financially prepared for retirement or that your investments are in good order. The reason is simply that an early death robs a person of the time needed to achieve their financial goals. It is one thing to plan for retirement in, say 15 years, or build up a capital sum over five to ten years. It is quite another to make sure your loved ones are provided for in the way you would want knowing that the date of your death could be anytime from today onwards.

Well over a million people currently have funeral plans in place. However, the true financial loss experienced by a family when a breadwinner dies is out of all proportion to the £4,000 or so that an average funeral costs. Someone aged 35 earning £50,000 a year with a £200,000 mortgage and children aged five and seven could easily find that their partner would need £1 million simply to make up for the loss of income over the next 18 years and the repayment of half of the mortgage.

Pure life insurance is not expensive

In fact, the monthly premium for an 18-year family income plan for that 35-year-old to provide £50,000 a year to their family in the event of their death could be as low as £25 a month. For them to provide £1 million in cash as an alternative using an 18-year level term insurance plan would still be possible for just under £45 a month.

How much is enough?

Of course, it's not possible to quantify the value of someone's life in purely financial terms. On the other hand, the ability to provide adequately for your family so that they can still fulfil their hopes and dreams is an act of love that itself cannot be measured.

As a minimum, it is generally important to cover any outstanding mortgage or other debts. If you are self-employed, you need to make sure that you have enough cover for business debts. For those with children, your priority should be to provide sufficient cover to replace your income until your children are no longer dependent and it would be prudent to assume at least age 23 for this. Parents should not overlook the fact that the surviving partner may need to meet the cost of university education or private school costs.

If you receive life insurance cover as a benefit of your employment, please bear in mind that this will need to be replaced if you change jobs and this may be at a time when your health could have deteriorated.

Although there is mention of the 'breadwinner' please be mindful of the true value of homemakers and insure with that in mind.

If you are single with no children, you should still be protecting your income from the risk of a serious illness or accident. Such things can undermine your ability to meet your financial objectives.

In any event, it is important to take individual advice based on your own particular situation, so please get in touch to review your life and health protection needs.

What is a £5,000 a year pension worth?

If you have pension benefits from an old private sector final salary pension scheme, they could be much more valuable than you think. So, how much is the right to a £5,000 a year prospective pension actually worth in cash equivalent transfer terms?

One of the answers to that £5,000 question – and there are many – is "a transfer value of 30 times the pension, in other words, £150,000".

If you're surprised, then you are not alone. Two years ago, such a transfer value figure would have been virtually unbelievable. Back in 2014, a multiplier of around 20:1 was common, making a £5,000 final salary pension worth around £100,000 if you were to transfer the fund close to retirement. The ratio of 20:1 ties in with HM Revenue & Custom's basis for valuing a pension for tax purposes – £1 of final salary pension is generally treated as being worth £20 of your lifetime allowance.

So why the big increase in transfer values?

The impact of interest rates

The main reason for the increases is the sharp drop in long term interest rates. For example, in early October 2014 the yield on the benchmark 30 year UK government bond (gilt) was marginally above 3.0%. Two years later the yield on gilts had halved to just 1.5%. Final salary pension schemes use long term yields to assess the value of their pension liabilities and so the value of those liabilities increases when bond yields fall. One side effect has been a large rise in company pension scheme deficits.

The pros and cons of transfer

There have even been suggestions in parliament that employers should be allowed to break their pension scheme promises in an effort to bring down deficits and escalating contribution levels. Some schemes have also increased their transfer values to encourage members with deferred pensions to leave, taking their escalating pension liabilities with them.

Transfer pros and cons

Exchanging £5,000 of pension for £150,000 of pension fund can have several advantages:

- The maximum tax-free lump sum you can draw is likely to be much higher – £37,500 instead of £23,076 assuming a typical 15:1 commutation basis.
- You will be able to take advantage of the pension flexibilities introduced in 2015, allowing you to draw as much of the fund as you wish, when you wish.
- Death benefits will often also be superior, particularly if you are single. Any pension fund remaining at death is normally inheritance tax free and the recipients also escape any income tax charge if you die before age 75.

However, there are significant disadvantages, too:

- You lose the promise of a known amount, usually with in-built increases once payment begins.
- You no longer have the back-up security provided by the Pension Protection Fund, if your employer fails.
- You will almost certainly not be able to turn the transfer value into a lifetime annuity equivalent to your scheme pension unless you are in very poor health. For example, to match a single life index-linked pension for a 65-year-old requires a transfer multiplier of over 37:1.

The decision on whether to transfer is complicated. If your transfer value is more than £30,000 – which could mean a pension of £1,000 a year – under government rules your pension provider must make sure that you have taken regulated financial advice based on your own particular circumstances before allowing any transfer to be made. We think that makes sense for any transfer.

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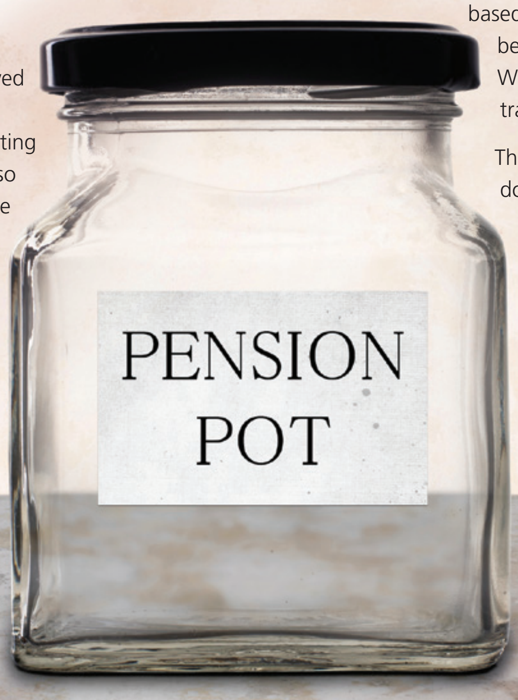

Tax evasion, avoidance and planning – righting wrongs

While others were enjoying August sunshine, HM Revenue & Customs (HMRC) was busy publishing consultation papers on tax avoidance and tax evasion.

As Theresa May announced in her final speech to October's Conservative Party Conference:

"So it doesn't matter to me who you are. If you're a tax-dodger, we're coming after you. If you're an accountant, a financial adviser or a middleman who helps people to avoid what they owe to society, we're coming after you too. An economy that works for everyone is one where everyone plays by the same rules. So whoever you are you – however rich or powerful – you have a duty to pay your tax. And we're going to make sure you do."

Three months earlier HMRC had started two separate consultations on tackling promoters of tax avoidance schemes and dealing with offshore tax evasion.

The attack on promoters – and others involved in the development, sale and use of schemes – is designed to "influence [their] behaviour". That "influence" will take the form of new penalties based upon the amount of tax that was purportedly avoided by the scheme's users if a scheme fails. At present it is usually only the taxpayer who suffers when a scheme is successfully challenged, while promoters and developers suffer little or no financial loss.

Making "corrections"

The latest move against offshore evasion proposes a "Requirement to Correct" if you have "undeclared UK tax liabilities in respect of an offshore matter". The "correction" must be made by September 2018 at the latest. After that date a Common Reporting Standard (CRS) is due to come fully into force.

Under the CRS, over 100 countries will automatically exchange taxpayer information, making evasion more difficult. Indeed, you probably would not want to have money invested in the countries outside the CRS.

HMRC is adopting a carrot and stick approach here because they would prefer tax evaders to confess voluntarily rather after an investigation. Thus the pre-CRS tax penalties will generally be lower than those under to "Failure to Correct" regime that begins in October 2018.

The targets for these consultations have nothing to do with what might be described as tried-and-tested financial planning and advice, such as we offer. The Prime Minister and HMRC are after aggressive avoidance schemes and tax evasion – which have always been illegal.

The value of tax reliefs depends on your individual circumstances. Tax laws can change. The Financial Conduct Authority does not regulate tax advice.

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