NLP Financial Management

NLPFM news

News and views from NLP Financial Management

Your 'get out of jail free' card

Over the past few years, fundamental changes have been made in the treatment of tax relief on pension contributions. The good news is that, from the start of the current tax year, a simpler regime will be replacing the Government's previous plans which included their complicated, interim, anti-forestalling arrangements. In general individuals will now be able to:

- Make tax-relieved annual contributions of up to £50,000.
- Obtain tax relief at their highest marginal rate on those contributions.
- Contribute more than £50,000 in any one year by 'carrying forward' unused allowances from the previous three tax years (see below).
- Build a pension fund worth £1.5m over their lifetime (Lifetime Allowance) without incurring any additional tax charge.

As you would expect, caution is required on a number of points:

Annual Contributions Limit of £50,000 for Tax Relief

- This limit is the total of all grossed up contributions to an individual's pension plans, including employer and 3rd party contributions.
- Employee or personal contributions remain limited to 100% of earnings for tax relief.
- Individuals can continue to make tax-relieved contributions of up to £3,600 per year without having any relevant earnings.
- Contributions in excess of the £50,000 limit may still be made but will be subject to a tax charge on the scheme member – not always a bad thing – it may for example help preserve Entrepreneurs' Relief in certain circumstances.
- Where a final salary (DB) scheme is in place, the notional contributions will be calculated as 16 times the increase in the annual pension benefit. So, an increase in the annual pension benefit of £750 will be deemed to have cost a contribution of £12,000.

But when is £50,000 not £50,000 – when it's £250,000! Carrying Forward Unused Allowances

- Unused 'headroom' from the previous three years may be carried forward, provided the individual was a member of a registered pension scheme during those years. There is no requirement to have been an active, contribution paying member nor any requirement stating you must have been capable of contributing.
- Contributions made in the current year are first allocated against the current year's allowance (£50,000) and any excess contributions are allocated first to the oldest year's unused allowance.
- Tax relief is available on personal contributions at the individual's marginal rate. But any such tax relief is limited to 100% of current year earnings in the current tax year.
- Regardless of the limits applying in recent years under the anti-forestalling rules, the carry-forward rules apply immediately. This means someone who has made no contributions in any of the past

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This newsletter is for general information only and should not be construed as a recommendation of any investment or service. We suggest that you contact us for independent financial advice so that we can determine the suitability of investments and services on an individual basis.

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three years, could have £200,000 of headroom in 2011/12. Additionally, by judiciously moving or closing ‘input periods’, a potential amount of up to £250,000 could be contributed, with tax relief obtained at the highest marginal rate in a single fiscal year.

Conclusion

Timing of earnings and contributions, both past and present are critical to safe navigation of the rules. Therefore, if you think that you might be at risk of exceeding the thresholds or want to maximize your pension contributions, at the same time as benefitting from full marginal rate relief, please contact your usual NLPFM adviser, to ensure that you capitalise on your opportunities.

For further information, please contact

Graham Mendoza-Wolfson
T 020 7433 2456
E graham.mendoza-wolfson@nlpfm.co.uk

Fixed income investing

Fixed income investments are debt instruments whereby an investor loans money to an entity for a defined period of time at a fixed interest rate (coupon). Once that period of time has lapsed (maturity date), the original loan or principal is returned to the lender. These bonds are used by both companies and governments to raise finance for a variety of projects and activities.

NLPFM allocate a proportion of our clients’ funds to a number of carefully selected fixed interest funds, which in turn purchase many of these bonds, either from companies or governments. These bonds will earn interest as well as providing the possibility of capital upside and the risk of capital loss. By using funds rather than individual bonds, you are diversifying this risk. Bonds are often considered a safe and uninspiring asset class, as returns can be less exciting than their equity counterparts. However, we believe that when managed efficiently, bonds are an excellent way to not only reduce volatility, but also add considerable value to a client’s portfolio.

Bonds can be categorised as follows:

- Government Bonds – These are typically considered the safest of all bonds but usually pay an interest rate comparable or marginally higher than cash rates.
- Investment Grade Corporate Bonds – These are generally issued by large, well known companies such as Tesco, who will offer a little more interest than Governments as they are considered slightly less safe.
- Non-investment Grade Bonds or High Yield Bonds – These are towards the higher end of the risk spectrum and are typically issued by smaller companies who will have to offer a higher rate of interest on the money they borrow, as there is a greater risk that they might not be able to repay the capital at maturity.
- Global Bonds – As well as the above options within the UK fixed interest sector, there is also the ability to invest in these same bonds within overseas markets. This widens the opportunity for investors, especially as some global bond managers will seek to enhance returns through the management of currencies.

When selecting bond funds within our portfolios, we manage risk through having exposure to different areas within the fixed interest sector. As always, we seek to add value through both asset allocation and stock selection. Accordingly, our favoured asset class has been Index-Linked Gilts, bonds issued by the UK Government, and so considered the safest around, with the interest payable being linked to inflation. Therefore, when inflation surprises on the upside they will outperform, which has been the case for the last two years, despite the general consensus in the industry that inflation is not an issue. This contrarian call has therefore rewarded our clients handsomely, whilst also having the positive affect of considerably reducing overall risk in our portfolios.

“bonds are an excellent way to not only reduce volatility, but also add considerable value to a client’s portfolio.”

After weighing up the risk/reward ratio, High Yield is another area we have favoured recently with our chosen fund returning around 30% over the last 3 years. Likewise our decision to take some Global bond exposure through the Franklin Templeton funds, has also reaped some excellent rewards. These funds will take currency calls, as well as interest rate calls, which gives an extra layer of diversification and also has the ability to enhance returns – as has been demonstrated with around 50% uplift over the last three years.

In conclusion, we believe opportunities abound within the fixed interest sector for the astute investor.

For further information, please contact

Lee Pittal
T 020 7433 2469
E lee.pittal@nlpfm.co.uk

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Private medical insurance – case study

Too often people receive renewal notices and just accept the enormous premium increase imposed on their Private Medical Insurance scheme.

A Company recently approached *Get Private* to see where we could save money on their group private medical insurance. The renewal premium proposed was around £15,000 per annum and this represented a substantial increase against the previous policy year. In the current economic environment, such increases are not only unacceptable but also unaffordable. However, the company felt it important to continue to offer employees private medical insurance, to ensure a speedy return to work after illness.

We conducted a full market review and as an independent healthcare specialist we were able to secure more favourable rates with a number of alternative providers. We also reviewed the level of benefits being offered by the different providers and eventually were able to offer the company a new policy with "increased benefits" for an annual premium substantially cheaper.

Our client was concerned that by changing insurer, they may jeopardise the ability to make claims on existing health conditions. However, due to our strong relationship with many providers, we are normally able to transfer companies on to new schemes on the basis of 'continued medical personal exclusions', i.e. only exclusions that are registered against an individual on the previous scheme will be included on the new scheme. This naturally gave our client the necessary assurances for them to proceed with the policy and save themselves a considerable sum.

We provide a free administration and claims handling service for all our clients and advise both individuals and companies. We do not charge directly for our service as we are remunerated by the insurance provider to cover our costs.

For further information, please contact

Sanjeev Mallipeddi
T 020 7472 3350
E sanjeev@getprivate.com

Discretionary management – the hidden benefits

We believe the main benefit of a Discretionary Management Service (DMS) is that it offers fund managers the facility for making and implementing decisions in a swift, efficient manner. This is especially important in a volatile market situation, when decisions need to be made and acted upon with no time lost.

However, there are additional benefits from a DMS which may not always be immediately apparent to the investor:

- **Management of capital gains** – it is important that clients utilise their annual capital gains allowances and this can easily be arranged via a discretionary manager. It may also be necessary, at times, to generate capital losses at the end of a tax year to offset substantial capital gains elsewhere.
- **ISA Investment** – Whilst many clients do not have the funds for yearly ISA contributions, they nevertheless require their investments to be managed for optimum tax-efficiency. A discretionary manager might therefore switch funds from unit trusts to ISAs, utilising a client's annual ISA allowance (£10,680), and thus ensuring all future gains remain free of income and capital gains tax.
- **Reporting Requirements** – it can be a cumbersome, time consuming and expensive exercise to collect tax vouchers from 20 different fund managers. This can be remedied by use of a DMS service, whereby all funds are held on the one platform. That platform can produce a consolidated report showing all tax events within the year.
- **Income Management** – the DMS service enables distributions from different fund managers, within a cash account, to be distributed as a regular payment to the investor. For example, should the client wish to receive a fixed monthly amount from their portfolio, this can be arranged as opposed to ad-hoc distributions at ad-hoc times.

The flexibility of the DMS service is one of its biggest advantages and we are delighted in the improvement to our client service since its introduction a number of years ago.

For further information, please contact

Adam Katten
T 020 7433 2433
E adam.katten@nlpfm.co.uk

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EIS Investments – higher risk investments but a variety of tax breaks

Enterprise Investment Schemes (EIS) are designed to help certain types of small unquoted trading companies to raise capital. They do this by providing a range of tax reliefs for investors.

30% Up Front Tax Relief. Subject to receiving EU approval, recent improvements to EIS legislation allow individuals to claim up to 30% relief against income tax on such investments up to a maximum of £500,000 each per tax year, from 2011/12 onwards. With higher rates of income tax hitting up to 50%, together with significant restrictions on pensions contributions and benefits, this opportunity is increasingly attractive for tax planning. EIS shares must be held for a minimum of 3 years from the date they are allotted to the investor for this relief to be retained.

No Capital Gains Tax. Provided that the shares are held for a minimum of 3 years, there is no CGT due on the proceeds. Some EIS funds aim to provide exits soon after the 3 year holding period, others run on indefinitely enabling investors to potentially shelter substantial capital gains.

Unlimited CGT Deferral Relief is also available, allowing for any CGT liability stretching over a 48 month period, to be deferred whilst the EIS investment is held. If the EIS is sold, then the deferred gain will revive and CGT at the prevailing rate will be due. The liability can be reduced further by timely judicious planning to maximise tax efficiency, such as timing disposals in order to utilise annual CGT allowances or inter-spousal transfers.

Inheritance Tax. Two years from the date on which shares are allotted, EIS investments generally fall outside the estate for IHT purposes. This potentially allows considerable assets to be preserved intact for dependants, without the current 40% inheritance tax liability.

All these tax allowances together make for a compelling proposition; although investors should not make investment decisions on the tax profile alone. The investment itself must have strong credentials and this should be considered a high risk product. However, whilst things can't always be guaranteed to run smoothly, the EIS has one last trick up it's proverbial sleeve. Should the investment fail to perform, Loss Relief can be claimed where a net loss is crystallised. This net loss can be offset against either income tax (in the current or previous tax year) or against capital gains. As an example, a 50% income taxpayer with a £50,000 investment which is a total loss, could already have received £15,000 of income tax relief, leaving £35,000 to be offset against income tax. This would result in a maximum exposure of £17,500 i.e. just 35%. So not actually a 100% loss at all – and certainly a great tax planning tool.

For further information, please contact

Andrew Butcher
T 020 7433 2458
E andrew.butcher@nlpfm.co.uk

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If you do not wish to continue to be on our database or receive any further correspondence from us, please write to Adam Katten at the address below.

NLP Financial Management Regina House 124 Finchley Road London NW3 5JS
T +44 (0)20 7433 2400 **F** +44 (0)20 7433 2401