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Pension / ISA planning

Aside from National Savings, the first port of call for most investors will be pensions and ISAs, and those who can afford to do so are usually advised to invest fully in both. But is that the end of the story?

Both pensions and ISAs offer a tax-free environment on the investment returns which are generated, but pension savings offer the great additional advantage that contributions benefit from up-front tax relief on contributions equal to the investor's marginal rate of tax.

Consequently, gross contributions of £10,000 cost a higher rate taxpayer £6,000, and the compounding benefit of this boost to capital is maintained until the fund is realised. In addition, when the fund is realised, 25% of the value can usually be drawn in the form of tax-free cash.

However, when income is drawn from the pension savings, whether in the form of annuity of income drawdown, this is subject to income tax at the recipients' marginal tax rates. By contrast, the income from an ISA is tax-free and capital can be withdrawn at any time, again with no tax liability. The ISA also wins in the event of the death of the investor, when the rate of inheritance tax payable will be 40%, whereas the corresponding rate for pension funds is usually 55%.

So, is it possible to have the best of both worlds? An arrangement which might be considered, particularly by those who expect to be subject to higher rate tax in retirement, would be to draw down income from the pension fund as from age 55 and apply this to purchase ISAs. The drawdown income would be taxable but the ISA income, also benefiting from tax-free growth, would not.

This could provide a useful increase in net income over time, and the tax rate on death would be lower. To maximise the benefit, ISAs could be bought for both partners in a relationship, and consideration might also be given to purchasing junior ISAs for grandchildren.

Gifting funds to children

Children under 18 years of age are unable to hold investments in their own name, and the time-honoured way of gifting a unit trust or OEIC to a child has been to designate the investment for the benefit of the child, by means of a bare trust. This permits the child's personal income tax allowance and capital gains tax exemption to be used to offset the tax charges on income and gains.

The exception to this principle is that income arising from assets placed in trust by parents for their minor children after 9 March 1999 is taxed as the donor's income if it exceeds £100 pa, regardless of whether it is paid or applied for the benefit of the child.

Trusts created prior to that date to which no new monies have since been added benefit from the previous rule whereby, even if it exceeds £100 pa, income which cannot be distributed is treated as the child's and benefits from the child's tax rate and personal allowance. Also, income produced by assets placed in trust by grandparents for their grandchildren will be taxed as the child's even if it exceeds £100 pa.

Income below the £100 limit which is rolled-up will be treated as belonging to the child, and tax deducted at source on interest received by the trustees (but not dividends) can be reclaimed up to the value of the beneficiaries' unused personal allowances. Likewise, on the disposal of assets, gains will have the benefit of the child's full annual exemption.

In England, Wales and Northern Ireland, these special provisions cease when the child attains the age of 18 or marries at an earlier age.

Since 6 April 2007, gains that arise due to a chargeable event on a life assurance policy which is held under a bare trust for a minor beneficiary are deemed to be the gains of the minor beneficiary rather than the settlor of the trust, as was HM Revenue & Custom's view before that date.

However, if the settlor of the trust is the parent of the child, and the gains exceed £100, the gains will continue to be assessed on the parental settlor.

Encashing small pensions

New rules are to be introduced this year which will permit people over 60 years of age to encash individual personal pension funds with a value not exceeding £2,000 even though their total pension savings are worth more than £18,000.

Currently, the encashment facility is open only to members of occupational pension schemes and those personal pension holders whose total pension savings are worth not more than £18,000. The apparent alternative to encashment is to apply the funds to purchase an annuity, but some personal pension holders who have been caught by the restriction have been prevented from annuitising because annuity providers will only accept pension pots valued at £5,000 or more.

There is, however, a proviso, namely that only two small pots can be encashed over a lifetime.

Charitable Gifting

With effect from 6 April 2012, estates which include charitable legacies equal to at least 10% of their net value will benefit from a 10% reduction in the rate of inheritance tax. So the rate will be 36% instead of them normal 40%.

The value of the concession, however, is uncertain. Most estates are of insufficient value to generate a liability to inheritance tax, and for those that could benefit, the relief will be complicated to administer and therefore costly for the taxpayer. And those who already donate significantly to charity are likely to continue to do so regardless of any incentive. In short, the concession may be a damp squib.

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