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State pension top-up

The State pension is to be increased from April 2016, when women entering retirement at the age of 63 and men retiring at age 65 will become entitled to a flat rate pension of around £155 per week.

The 12 million people who have already attained State pension age will miss out on the increase, but they will have the opportunity for an 18 month period starting in October 2015 to buy additional State pension to top them up to the new rate.

Each additional £1 of pension purchased will cost a 65-year old man £890, and the maximum top-up of £25 will cost £22,250. Payments will rise in line with inflation, and surviving spouses and civil partners will be able to inherit 50% of the benefit

This new facility is additional to the existing arrangement whereby State pension entitlement can be increased by purchasing extra years to make up for any shortfall in the number of years for which National Insurance contributions have been paid.

Thirty years' payment ensures a full State pension under the existing rules, and the Government is urging people to secure the maximum number of years before considering the new facility, because the cost of buying extra years is much lower: £890 will buy a 65 year-old an extra pension of £4.64 per week.

In the same way as when buying an annuity, buying additional State pension will mean exchanging cash for a future income. However, the income purchased will be higher than could be obtained from an annuity.

The cost will depend on the prospective lifespan of the purchaser. So older purchasers will pay less; and the longer they live, the better value they will receive. The scheme is likely to appeal to the self-employed and women with broken work records, but to be of less interest to people with health problems and higher rate taxpayers.

Benefiting grandchildren

The dilemma faced by many generously-disposed grandparents is how to benefit their grandchildren financially without running the risk that they will squander the money.

The solution which immediately comes to mind is to set up a discretionary trust, which confers no rights on the beneficiaries but enables the trustees to make payments in their discretion.

However, discretionary trusts lack the tax-efficiency of bare trusts, which are tantamount to outright gifts but deny the beneficiaries title to the trust investments until they reach the age of 18.

Arguably, the best of both worlds could be achieved if the trustees of the discretionary trust were to exercise their right to make absolute appointments of the trust funds to bare trusts for beneficiaries under the age of 18. Any capital gain which had occurred since the discretionary trust was set up would then fall on the minor beneficiary, and their income tax personal allowance or capital gains tax exemption could be used to reduce or eliminate tax on the gain.

The appointments to the bare trust could be made to cover specific financial needs as they arose, and meanwhile the remainder of the trust funds would remain sheltered in the discretionary trust.

Dividends received on investments held in bare trust are accompanied by a tax credit, so basic rate taxpayers have no liability to income tax whether the income is received or accumulated. However, if the investments were transferred to grandchildren, they would be subject to capital gains tax on any increase in value since the date when the bare trust was established.

As an alternative to setting up a trust, parents and grandparents can buy Junior ISAs on behalf of their offspring. These are completely free of tax but the maximum annual investment is only £3,720 (increasing to £4,000 as from 1 July 2014).

Inheritance tax savings

Simple precautions can avoid the need to pay inheritance tax on life policies and pension plans.

In the case of life policies, these can and should usually be written in trust so that the benefit falls outside the taxable estate of the policyholder. A discretionary trust might be suitable, with the policyholder's partner as the principal potential beneficiary, together if appropriate with any children of a previous marriage.

In the case of pension plans, a 'letter of wishes' should always be written by the planholder to the scheme trustees indicating the person or persons to whom they would wish the value to be paid in the event of their death.

There are, unfortunately, some scheme trustees who are unwilling to follow expressions of wishes and insist on paying plan proceeds to the planholder's estate. Consideration might be given in these cases to switching to a more accommodating pension scheme.

As an alternative to an expression of wishes, a formal 'spousal by-pass trust' might be established in relation particularly to larger pension arrangements. This would give the trustees discretion to pay the proceeds to a wide range of potential beneficiaries, including the surviving spouse, but would enable them to ensure that the surviving spouse received only what he or she needed, so that the balance of the fund would escape tax on their death.

The first £325,000 of the assets held in a discretionary trust are exempt from inheritance tax, and some taxpayers have set up several trusts in the hope that the exemption will apply to each of them. However, the Government is planning to introduce provisions preventing this practice, possibly with retrospective effect.

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