



January 2012

# Financial update

Although it is early in the year, the end of the tax year is less than three months away. Traditionally, now is the time to review your personal and family finances, pay your tax bills, top up your pension and utilise your annual ISA, Capital Gains Tax, VCT and EIS allowances.

We have prepared a series of articles covering these topics and this Update discusses two of them. The first concerns family protection, arguably the most important issue, whilst the second deals with an urgent aspect of pension planning.

A further Financial Update will be issued in February covering the other key issues.

## THE 'PROTECTION GAP'

We have previously commented on various aspects of the 'protection gap'; the difference between the amount of life assurance and income protection people have and the amount that they actually need.

Many leave the provision of life assurance and pensions to their employers, although unfortunately they do not consider whether, in the event of a claim, the benefits provided would be sufficient to allow a reasonably comfortable lifestyle to be maintained.

Most people in employment or self employment have life assurance that will provide a lump sum (typically 2–4 x their annual income) in the event of their death before retirement. Insurance industry statistics indicate that there is a much higher probability of an individual having an accident or suffering ill health that leads to long term absence from work. Insuring against the resultant loss of income from this is much less common.

### Adequacy of cover - assets and insurance

In the event of death, the value of any life assurance policies can be added to the value of any pension funds, savings and investments. It is currently considered that drawing an annual income equivalent to 4–5% of the aggregate value of pension/ savings/ investments should be sustainable over the medium to long term.

Simply put, if your life assurance/ pensions/ savings are worth £500,000, your next of kin can look forward to an ongoing annual income of £20,000 –25,000. This income may or may not be taxable depending on how the funds are invested.

In the event of absence from work most employers would continue to pay salaries for a reasonable period. If the period of absence was prolonged, then once employer support ended residual income would comprise state benefits plus any pension and investment income. Again, the 4–5% income guideline would apply.

Affected individuals who are well funded could opt for an earlier than expected retirement. Those perhaps further away from retirement, with fewer resources or with significant ongoing commitments, may find themselves in difficulty.

### Insurance options

Additional life assurance can be sought, which can provide an additional lump sum or a tax free income in the event of death.

It is possible to insure your income: income replacement insurance (also known as permanent health insurance or PHI) can provide a tax free income benefit of up to 50% of your full salary/ income in the event that you are unable to work for a prolonged period due to accident or illness. The benefit is paid following a waiting period until the first of either recovery and return to work, retirement or death. This is considered a very valuable type of cover as it provides long term income security.

Critical illness cover can also be useful. It provides a tax free lump sum in the event that you survive for a period following the diagnosis of one from a list of specific 'critical' medical conditions, eg. cancer, stroke, heart attack etc.

The types of insurance described above are unnecessary if you have sufficient accessible assets to effectively self insure. If you have insufficient accessible assets however, then insuring the shortfall is the practical option.



You should consider whether your current life assurance and pensions provision will be sufficient to allow for a comfortable lifestyle.





The costs of providing appropriate levels of cover vary widely depending on age, health, lifestyle and the sum assured.

Family protection is hugely important, but it is not straight forward. There are numerous options and it is very important that you seek professional advice to determine the correct type and levels of cover to suit your circumstances.

## THE PENSION LIFETIME ALLOWANCE AND FIXED PROTECTION

In September 2011 we highlighted the fact that you should apply for fixed protection if your pension has a value approaching or in excess of the life time allowance which is currently £1.8 million.

To recap; if your pension fund has a value in excess of the lifetime allowance when you retire it will be subject to a recovery charge. This will be equivalent to 55% of the value of your pension in excess of your lifetime allowance.

**The value of the lifetime allowance is to be reduced from £1.8 million to £1.5 million in April 2012.**

If you apply for fixed protection you will secure a protected lifetime allowance of £1.8 million. This could potentially save you a recovery charge of up to £165,000. Unfortunately however, if you apply for fixed protection you must stop the accrual of pension benefits after 5 April 2012. If any contributions are made or if there is any relevant pension accrual after that date, you will lose your fixed protection.

This change may affect you even if your pension fund does not have a value close to the current or reduced lifetime allowances. For example, if your pension is currently worth £838,000 and you have ten years until your planned retirement, then was your pension fund to grow at 6% per annum it would use up all of your £1.5 million lifetime allowance without any further contributions being needed. Was this to happen any ongoing contributions would therefore only be of marginal benefit.

**Where possible you should utilise the current higher lifetime allowance.**

If the value of your pension could exceed the new lower £1.5 million lifetime allowance because of its size and/or the term to your retirement, you should consider making an immediate additional pension contribution then applying for fixed protection. The investment growth on your increased fund over the term to your retirement will hopefully ensure that you utilise all of your £1.8 million lifetime allowance.

Whilst in recent years tax efficient pension funding has been difficult due to the anti-forestalling rules, this is no longer the case. The new contribution rules allow tax relieved contributions of up to £50,000 per annum and as unused relief can be brought forward for up to three years, contributions of up to £200,000 can be paid this year.

**If you require further advice on any of the above, then please contact your usual UHY Hacker Young partner.**

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