



AF3

THE CHARTERED INSURANCE INSTITUTE

TUESDAY 20 APRIL 2010

**ADVANCED DIPLOMA IN FINANCIAL PLANNING
AF3 – PENSION PLANNING**

SPECIAL NOTICES

- **All questions in this paper are based on English law and practice applicable in the tax year 2009/2010, unless stated otherwise and should be answered accordingly.**
- **Assume all individuals are domiciled, resident and ordinarily resident in the UK unless stated otherwise.**
- **Candidates should answer based on the legislative position immediately BEFORE the 2010 Budget.**

INSTRUCTIONS

- **Three hours are allowed for this paper.**
- **Read the instructions overleaf carefully before answering any questions.**
- Fill in the information requested on the answer book and form B.
- If you bring a calculator into the examination room, it must be a silent battery or solar-powered non-programmable calculator. The use of electronic equipment capable of being programmed to hold alphabetic or numerical data and/or formulae is prohibited. You may use a financial or scientific calculator, provided it meets these requirements and you must enter the serial number, model and make on the form B.
- You are allowed to write on the inside pages of this question paper but you must **not** write your name, candidate number, PIN or any other identification **anywhere** on this question paper.
- The answer book and this question paper **must both be handed in personally by you** to the invigilator before you leave the examination room. **Failure to comply with this regulation will result in your paper not being marked and you may be prevented from entering this examination in the future.**

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AF3—Pension planning

CANDIDATE INSTRUCTIONS

READ THE INSTRUCTIONS BELOW BEFORE ANSWERING ANY QUESTIONS

Three hours are allowed for this paper. You should answer **all** questions in Sections A and B.

The paper carries a total of 160 marks, as follows:

Section A: 80 marks

Section B: 80 marks

You are advised to spend approximately 90 minutes on Section A, and 90 minutes on Section B. You are strongly advised to attempt **all** the required questions to gain maximum possible marks.

The number of marks allocated to each question part is given next to the question and you should spend your time in accordance with that allocation.

Any rough notes made in your answer book must be crossed through before you hand it in.

Tax tables are provided at the back of this paper.

Answer each question on a new page and leave six lines blank after each question part.

It is important to show all steps in a calculation, even if you have used a calculator.

Please ensure that you understand the Special Notices printed in the box on the front page.

Subject to providing sufficient detail, you are advised to be as brief and concise as possible, using note format and short sentences on separate lines wherever possible.

SECTION A

This question is compulsory and carries 80 marks.

Question 1

Arthur Potter, aged 57, was made redundant last year. He is a widower and has no financial dependants. He is in good health but is a smoker. He has no debts and used most of his redundancy payment to repay his mortgage. He has only modest savings. On his death he would like to provide for his two sons, Hugh and Lewis. He has a moderate attitude to risk.

He has been unsuccessful in finding alternative employment and is considering setting up his own business restoring antique furniture. To do so he will need a modest amount of additional capital. He also realises that it will not provide enough income to support him, particularly in the first couple of years.

Arthur is a deferred member of his former employer's contracted-out final salary scheme. He has just received a letter from his former employer offering him a cash equivalent transfer value (CETV) of £348,000. This includes protected rights of £145,000.

You have obtained a Transfer Value Analysis System (TVAS) report and also an immediate early retirement benefit quote from the scheme. The immediate retirement benefits available from the scheme are as follows:

Immediate pension	£16,750
or pension commencement lump sum (PCLS)	£73,814
and a reduced pension	£11,072

You have also obtained lifetime annuity rates and the most competitive rates for smokers are as follows:

	<i>Male</i>	<i>Unisex</i>
Single life level pension	6.5%	5.9%
Single life pension escalating at 3% per annum	4.4%	3.9%

He has asked you to advise him on his options. In particular he is interested in accessing benefits immediately, as this would greatly assist him in establishing his proposed new business.

Questions

- (a) With regard to the pension commencement lump sum (PCLS) that is available immediately from the defined benefit scheme:
- (i) calculate, **showing all your workings**, the commutation factor being used by the scheme; (2)
 - (ii) calculate, **showing all your workings**, how the £73,814 PCLS represents 25% of the value of Arthur's benefits in the scheme. (4)
- (b) Arthur has concerns over the security of his benefits if he accepts an early retirement pension from the defined benefit scheme, as he has heard that his former employer is struggling financially.
- (i) State the circumstances in which his early retirement benefits could be at risk. (3)
 - (ii) Assume the scheme enters the Pension Protection Fund (PPF) while Arthur is in receipt of a pension but before the scheme's normal retirement date. Explain in detail how his pension would be calculated and the proportion that would be protected. *No calculation required.* (6)
 - (iii) State the amount of inflation protection that would be provided if Arthur's benefits were being paid by the PPF. (3)
- (c) The Transfer Value Analysis System (TVAS) report has indicated that the critical yield to the scheme's normal retirement age is 6.9% falling to 5.8% if the maximum PCLS is taken.
- (i) Explain why the critical yield is different if the maximum PCLS is taken. (4)
 - (ii) Comment on the importance of these critical yields if Arthur was to take immediate benefits and state, giving your reasons, the alternative critical yields that should be considered. (5)

- (d) If Arthur was to accept the transfer value offered and immediately crystallise all of his benefits:
- (i) calculate, **showing all your workings**, the maximum PCLS that would be payable; (2)
 - (ii) assuming he takes the maximum PCLS, calculate, **showing all your workings**, the lifetime annuity that would be payable, both:
 - level; (8)
 - escalating at 3%. (8)
 - (iii) State the factors that could influence the annuity rate that would be offered to Arthur by an insurance company. (11)
 - (iv) State, giving your reasons, why Arthur might benefit by deferring the purchase of an annuity from the protected rights fund, at least for a couple of years. (6)
 - (v) The maximum income available if Arthur opted for income withdrawal from an unsecured pension (USP) would be £16,500. Explain why this is not 120% of the level pension identified in (d)(ii) above. (2)
- (e) Taking account of Arthur's personal circumstances and objectives, outline the **benefits** and **drawbacks** of the following options:
- (i) an immediate early retirement pension from the scheme; (8)
 - (ii) accepting the cash equivalent transfer value (CETV) offer in order to take benefits immediately. (10)
- (f) Arthur decides to accept the transfer value offered. State, giving your reasons, how he should use the transfer value to meet his objectives. (6)

Total marks available for this question: 80

Section B questions can be found on pages 8 – 10

SECTION B

**Both questions in this section are compulsory
and carry an overall total of 80 marks.**

Question 2

Sarah Lucas, aged 35, is divorced with two children, aged four and seven. In 2008, she set up SL Supplies Ltd. The company is now profitable and she is planning an expansion which will necessitate the purchase of a small warehouse.

Sarah is also taking this opportunity to review her pension arrangements and is keen to establish if she can use pension funds in a way that will help with her business expansion plans. She has a speculative attitude to investment risk.

Prior to setting up in business, Sarah was employed by a large multi-national corporation and was a member of their contracted-out defined benefit scheme. She is now a deferred member of the scheme. On death before retirement, the scheme offers a spouse's pension but no other form of death benefit.

Sarah's previous employer has now closed its defined benefit scheme to new entrants. Sarah is concerned by this and feels that the company might be in financial difficulties. As a result she is wondering whether she should move her pension benefits to a personal pension plan.

When Sarah left employment she received a statement showing her pension entitlement at the scheme's normal retirement age and the cash equivalent transfer value (CETV) available should she wish to transfer her benefits. She recently requested this information again and was surprised to see that the CETV had increased considerably.

Questions

- (a) Explain in detail why Sarah's cash equivalent transfer value (CETV) may have increased in value. (5)
- (b) Sarah has obtained a pension Transfer Value Analysis System (TVAS) report which shows that the critical yield is 7.1%. Explain the term critical yield. (6)
- (c) Based on the information provided in the case study, state, giving your reasons, **five** factors that would influence Sarah's decision to transfer. (10)
- (d) Sarah has received a suitability letter from her advisor recommending a transfer to a self-invested personal pension (SIPP). Outline the purpose and content of this letter. (9)
- (e) Having transferred to a SIPP, Sarah identifies a suitable warehouse. Its value however is greater than the value of her SIPP.
- (i) State the extent to which the SIPP can borrow to fund the purchase. (2)
- (ii) State **five** advantages and **three** disadvantages to Sarah of using the SIPP to buy the property. (8)

Total marks available for this question: 40

Question 3

John Adams, aged 52, is married with two grown-up children. John has been employed as a management consultant at Olympus Consulting Ltd since 2005. He earns a salary package of £146,000 per annum. In addition, he has earned bonuses of £15,000 in each of the last three years.

His employer has paid £1,000 per month into John's self-invested personal pension (SIPP) since he commenced employment with them. John also made single contributions to his SIPP of £27,500 in 2007/2008 and £40,000 in 2008/2009.

John has a sizeable investment portfolio, which in 2009/2010 generated net dividends of £8,700 and net interest of £2,400. His wife also has a sizeable investment portfolio, inherited following the death of her father. They also jointly own a flat which is rented out.

John is considering making an additional pension contribution. He has asked for your comments on his position with regard to the high earner rules on pension contributions and whether an Individual Savings Account (ISA) may be a better vehicle for his contribution than his SIPP. He is also concerned about Inheritance Tax (IHT).

Questions

- (a) State the elements that make up 'relevant income' for the purpose of determining whether a special allowance charge could apply to John. (7)
- (b) Calculate, **showing all your workings**, the amount that John could contribute to his self-invested personal pension (SIPP) before a special annual allowance charge would apply. (9)
- (c) State, giving your reasons, **four** ways in which John may be able to reduce his relevant income in the future. (8)
- (d) John has currently nominated his wife as sole beneficiary in respect of the death benefits from his SIPP. Explain why it would be more appropriate for John to nominate a discretionary trust of which his wife and children are potential beneficiaries. (8)
- (e) List **four** advantages and **four** disadvantages of using an ISA to provide for his retirement compared with a SIPP. (8)

Total marks available for this question: 40

TAX TABLES

INCOME TAX RATES

2009/2010		2008/2009	
Rate	Band	Rate	Band
%	£	%	£
10	1 - 2,440*	10	1 - 2,320*
20	1 - 37,400	20	1 - 34,800
40	Over 37,400	40	Over 34,800

* A new 10% starting rate is applied for savings income only from 06.04.2008. Only applicable where non-savings income after allowances is under £2,440 for 2009/2010.

NATIONAL INSURANCE CONTRIBUTIONS

2009/2010 Rates

Class 1 Employee	Weekly	Monthly	Yearly
	£	£	£
Lower Earnings Limit (LEL)	95	412	4,940
Upper Earnings Limit (UEL)	844	3,656	43,875
Upper Accruals Point	770	3,337	40,040

Class 1 Employee contributions 2009/2010

Total earnings £ per week	Contracted-in rate	Contracted-out rate
	%	%
Up to 110.00*	Nil	Nil
110.01 – 770.00	11	9.4
770.01 – 844.00	11	11
Above 844.00	1	1

Class 1 Employer contributions 2009/2010

Total earnings £ per week	Contracted-in rate	Contracted-out rate	
	%	Final salary	Money purchase
	%	%	£
Below 110.00**	Nil	Nil	Nil
110.01 – 770.00	12.8	9.1	11.4
770.01 – 844.00	12.8	12.8	12.8
Excess over 844.00	12.8	12.8	12.8

* This is the primary threshold below which no NI contributions are payable. However, the lower earnings limit is £95 per week. This £95 to £110 band is a zero rate band introduced in order to protect lower earners' rights to contributory State benefits e.g. Basic State Pension.

** Secondary earnings threshold.

Class 2 (self-employed) Flat rate per week £2.40 where earnings exceed £5,075 per annum.

Class 3 (voluntary) Flat rate per week £12.05

Class 4 (self-employed) 8% on profits between £5,715 - £43,875 plus 1% on profits above £43,875

INCOME TAX RELIEFS

	2009/2010	2008/2009
	£	£
Personal (basic)	6,475	6,035
Personal (age 65-74)	9,490	9,030
Personal (aged 75 and over)	9,640	9,180
Married/civil partners (minimum) at 10% †	2,670	2,540
Married/civil partners (age under 75) at 10% †	N/A	6,535
Married/civil partners (age 75 and over) at 10%	6,965	6,625
Age-related relief reduced by 50% of income over	22,900	21,800
Child Tax Credit (CTC)		
family element	545	545
family element baby addition	545	545
CTC usually reduced by 6.67% of joint income over	50,000	50,000
Blind person's allowance	1,890	1,800
Enterprise Investment Scheme relief limit @ 20%	500,000	500,000
Venture Capital Trust relief limit @ 30%	200,000	200,000

† where at least one spouse/civil partner was born before 6 April 1935

PENSIONS

Lifetime Allowance		Annual Allowance	
2006/2007	£1.5 million	2006/2007	£215,000
2007/2008	£1.6 million	2007/2008	£225,000
2008/2009	£1.65 million	2008/2009	£235,000
2009/2010	£1.75 million	2009/2010	£245,000
2010/2011	£1.8 million	2010/2011	£255,000

Notional Earnings Cap

£123,600 – (For schemes that require post 1989 benefits to be still subject to a cap)

Annual allowance charge

40% member's tax charge on the amount of total pension input in excess of the annual allowance.

Lifetime allowance charge

55% of excess over lifetime allowance if taken as a lump sum.

25% of excess over lifetime allowance if taken in the form of income, which is subsequently taxed under PAYE.

CAR AND FUEL BENEFITS

The charge for company car benefits is based on the carbon dioxide (CO₂) emissions. There is no reduction for high business mileage users.

For 2009/2010:

The percentage charge is 15% of the car's list price for CO₂ emissions at or below the qualifying level of 135g/km.

The base percentage charge of 15% increases in 1% steps for every additional full 5g/km over the 135g/km threshold, up to a maximum of 35% of the car's list price.

A lower percentage charge of 10% of the car's list price applies for emissions at or below 120g/km.

If price of car exceeds £80,000 then its price for tax purposes will be fixed at £80,000.

There is an additional 3% supplement for diesel cars not meeting Euro IV emission standards or registered after 31 December 2005. However, the maximum charge remains 35% of the car's list price.

Car fuel The benefit is calculated as the CO₂ emissions % relevant to the car and that % applied to a set figure (£16,900 for 2009/2010) e.g. car emission 160g/km = 20% on car benefit scale. 20% of £16,900 = £3,380.

Notes:

1. **Accessories** are, in most cases, included in the list price on which the benefit is calculated.
2. **List price** is reduced for capital contributions made by the employee up to £5,000.
3. **Car benefit** is reduced by the amount of employee's contributions towards running costs.
4. **Fuel scale** is reduced only if the employee makes good **all** the fuel used for private journeys.
5. **All car and fuel benefits** are subject to employers National Insurance Contributions (Class 1A) of 12.8%.

PRIVATE VEHICLES USED FOR WORK

2009/2010 rates

Cars

On the first 10,000 business miles in tax year 40p per mile

Each business mile above 10,000 business miles 25p per mile

Motor Cycles 24p per mile

Bicycles 20p per mile

INHERITANCE TAX

	2009/2010	2008/2009
Nil-rate band*	£325,000	£312,000
Rate of tax on excess	40%	40%
Lifetime transfers to and from certain trusts	20%	20%
Overseas domiciled spouse/civil partner exemption	£55,000	£55,000

100% relief: businesses, unlisted/AIM companies, certain farmland/building

50% relief: certain other business assets

Reduced tax charge on gifts within 7 years of death

	0-3	3-4	4-5	5-6	6-7
Years before death					
% of death charge	100	80	60	40	20
Annual exempt gifts	£3,000 per donor			£250 per donee	

* From 8 October 2007 up to 100% of the unused proportion of a deceased spouse's/civil partner's nil-rate band can be claimed on the surviving spouse's/civil partner's death.

MAIN SOCIAL SECURITY BENEFITS

		From 06.04.09	From 06.04.08
		£	£
Child Benefit	first child	20.00	20.00*
	subsequent children	13.20	13.20*
Incapacity Benefit	short-term lower rate**	67.75	63.75
	short-term higher rate**	80.15	75.40
	long-term rate	89.80	84.50
Attendance Allowance	lower rate	47.10	44.85
	higher rate	70.35	67.00
Retirement Pension	single	95.25	90.70
	married	152.30	145.05
Pension Credit	single person standard minimum guarantee	130.00	124.05
	married couple standard minimum guarantee	198.45	189.35
	maximum savings ignored in calculating income	6,000	
	increased from November 2009	10,000	
Bereavement Benefit (lump sum)		2,000.00	2,000.00
Widowed Parent's allowance		95.25	90.70
Jobseekers Allowance		64.30	60.50

* From 5 January 2009

** Under State Pension Age

VALUE ADDED TAX

Standard rate	15%*/17.5%**
Annual registration limit - from 1 May 2009	£68,000

* Effective from 1 December 2008

** Effective from 1 January 2010

CORPORATION TAX

Financial Year	2009 to 31/3/10	2008 to 31/3/09
Full rate	28%	28%
Small companies rate	21%	21%
Small companies limit	£300,000	£300,000
Effective marginal rate	29.75%	29.75%
Upper marginal limit	£1,500,000	£1,500,000

CAPITAL ALLOWANCES

Plant & machinery 100% annual investment allowance (first year)	£50,000
Plant & machinery in excess of annual investment allowance (first year)	40%
Plant & machinery, patent rights, know-how (reducing balance) per annum	20%
Certain long-life assets, integral features of buildings (reducing balance) per annum	10%
Industrial & agricultural buildings (straight line)	2%
Energy & water-efficient investments	100%
Qualifying flat conversions & business premises renovations	100%
Motor cars: with emissions in excess of 160g/km	10%
generally	20%*
with CO2 emissions of 110g/km or less	100%
Research & Development: Capital expenditure	100%
Revenue expenditure - small/medium-size firms	175%
- large firms	130%

* Maximum £3,000

CAPITAL GAINS TAX

Exemptions	2009/2010	2008/2009
Individuals, estates etc	£10,100	£9,600
Trusts generally	£5,050	£4,800
Chattels proceeds (5/3 excess gain is taxable)	£6,000	£6,000
Rates		
Individuals	18%	18%
Trusts and estates	18%	18%

ENTREPRENEURS' RELIEF

Entrepreneurs' Relief 2009/2010

4/9^{ths} of gain tax free. Lifetime limit eligible for relief: £1,000,000

For trading businesses and companies (minimum 5% employee shareholding) held for 1yr+

