MAKING THE MOST OF A LUMP SUM

Alliance Trust Savings

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Tax treatment depends on individual circumstances and may be subject to change in the future.

The information here is our understanding in September 2018.

GETTING STARTED

Coming in to a lump sum of money can be a great opportunity to improve your financial security. Used wisely it could have a long lasting and positive impact on your wealth, especially if you are looking at a considerable sum.

What that means for you depends, of course, on your personal circumstances and goals. From working out what your lump sum might be once tax is taken into account, through to coming up with your final plan for making the most of your money, this guide will give you an idea of how to approach things and some of the topics to consider.

It is divided into four main sections:

1

Initial considerations

The source of your lump sum, and what that might mean for the tax you pay.

2

Covering the basics

Making sure that your family and household finances are as secure as you would like.

3

Setting priorities for the rest

Getting the most from the remaining lump sum, depending on your life stage and personal goals.

4

Investment decisions

Managing risk and making your money work as hard for you as possible.

Alliance Trust Savings does not give financial or investment advice. We offer what's known as an 'execution only' service. This means that we only do what you ask us to do. We won't offer an opinion on the suitability or merits of a particular fund or trade. If you feel you need advice, you should consult a financial adviser.

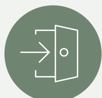
INITIAL CONSIDERATIONS

Here's a quick look at some of the main forms of lump sum and the tax headlines you'll need to think about in each case.

A bonus

Income tax will be payable on a bonus at your marginal rate, as bonuses are treated as part of your remuneration. If it's being paid to you as part of your salary it will be taxed through the PAYE system, but if it's from another source it will have to be taxed through your self-assessment tax return.

It's worth checking whether you employer offers salary sacrifice (sometimes known as salary exchange) on your bonus. This is where you technically give up some or all of your salary in exchange for a contribution to your workplace pension scheme (or to your personal pension or SIPP, if you have an arrangement whereby your employer pays contributions into it). If your employer does offer salary sacrifice, depending on the size of your bonus the tax and national insurance (NI) due on it could potentially be reduced, while boosting your pension pot.



A redundancy or severance payment

These are not classed as earnings and the first £30,000 is tax free. Even if a redundancy payment is over £30,000 it is still free of NI contributions, although your employer will take tax and NI contributions from any unpaid salary or holiday pay that it owes you.

There can be some distinctions depending on the nature of the severance, however. For example, if an employer is paying you damages after being found in breach of your contract, the first £30,000 is again tax-free. However, any payments made in lieu of notice will from April 2019 be liable to income tax and NI.

An inheritance

This is where the tax treatment of lump sums can sometimes – but not always – become more complicated. A great many estates are below the level at which they incur inheritance tax (IHT), with the basic nil rate band currently going up to £325,000.

A compensation payout

These can come in all shapes and sizes, from insurance claim proceeds to payouts arising from work-related accidents. Their tax treatment can differ significantly and can vary between types of payment, so it's always worth seeking clarification from HMRC, an accountant or financial adviser.

For example, compensation paid for personal injury is generally exempt from tax, but that paid following a financial loss related to an asset (such as a house sale that has collapsed) is usually liable to CGT.

A lottery or premium bond win

These are entirely tax free.

Tax on your inheritance: A closer look

IHT is charged at 40% on the amount of any inheritance passed on above the nil rate band.

As well as the basic nil rate band, if you're a direct descendant of the person you inherited from, and they are passing on what was their main home to you, the estate may also benefit from an additional nil rate band for IHT known as the main residence nil rate band. Currently this is £125,000, rising to £175,000 by the 2020/21 tax year.

Where a spouse or civil partner dies and their estate doesn't use its full nil rate band and additional nil rate band, the left over can be transferred to the estate of the survivor. So in some cases you can potentially inherit a substantial sum without any IHT being due.

If IHT is due, the amount may also depend to some extent on any other steps taken to mitigate it by the person that left you their estate, for example through the use of trusts and any financial gifts they may have given you while they were still alive.

IHT is usually paid direct from the estate or from funds raised from the sale of its assets, though some people leave cash or insurance policies designed to cover IHT liabilities. Beneficiaries receive what's left of the estate, once tax and debts have been paid.

IHT isn't the only tax that could be charged on an inheritance. If you've been left assets that provide you with an income (such as shares or rental property) you might have to pay Income Tax on that income. You might also have to pay Capital Gains Tax if you sell inherited assets for more than they were worth when you received them.

COVERING THE BASICS

Once you know how much (if any) tax you might have to pay on your lump sum, it's time for the more rewarding business of how you can best make your money work for you.

It's generally a good idea to start by making sure you have the financial basics covered.

Clearing debts

Perhaps the first big step you can take is to consider clearing or reducing any debts you have. Unsecured debt with high interest charges, such as any outstanding unsecured loans, credit cards, store cards and overdrafts should be top of the list, with the most expensive paid off first.

If you don't have unsecured debts you could turn to what for most people is the biggest financial commitment they have – your mortgage. The current low interest rate environment could make it a good time to overpay your mortgage for a while – or put in a lump sum if the terms of your mortgage allow – potentially taking years off the repayment period.

Most mortgages allow penalty-free overpayments of up to 10%, but it's worth asking your lender first to clarify exactly how much flexibility it offers.

Putting money aside for emergencies

Another opportunity you can take is to build or bolster your emergency savings, providing you with both a financial buffer and invaluable peace of mind should you find yourself falling on lean times. How much you might need to set aside depends on your own personal circumstances, but as a general rule of thumb you could aim for savings equivalent to between three and six months of pay, in order to cover expenses and emergencies.

The right savings or investment products for you will also depend on your own personal circumstances. Yet there are tax breaks worth bearing in mind when deciding the best route for you.

Cash ISAs offer shelter from both income and capital gains tax on any interest earned.

Basic rate and higher rate tax payers also have a tax-free savings allowance (the Personal Savings Allowance) of £1,000 or £500 respectively that they can offset against any interest earned on savings outside of an ISA. Additional rate tax payers do not qualify for this allowance. If you live in Scotland and pay different rates of income tax, the rates for the rest of the UK are used for working out your entitlement to the Personal Savings Allowance.

Tax rates and allowances

Use our latest *Tax Tables* to check on the main tax rates and allowances that may be available to you. Our *Tax Tables* document can be downloaded from our website at **alliancetrustsavings.co.uk**.

COVERING THE BASICS (continued)

Protecting your family

Another check you might want to make is that you have all the necessary financial protection in place for yourself and your family. Your lump sum might offer a buffer of sorts, but household finances can quickly be undermined by illness, injury or death.

Should the worst happen, life insurance can make a big difference to the financial security of your loved ones, especially if you have a mortgage.

Income protection and critical illness plans can provide a further layer of protection. The former is in some ways the ultimate rainy day fund, paying out an income in the event of the policyholder being unable to work due to illness or an accident. The latter provides a lump sum payment in the event of the diagnosis of one of a specific list of serious illnesses.

Boosting a child's future

Another thing you could consider is setting aside or boosting a fund for any children in the family. For example, up to £4,260 can be saved each year into a Junior ISA. This fund belongs to the child who can do as they like with it from age 18.

Up to £2,880 can also be saved into a pension each year for a child, and the government will automatically top this up through tax relief to £3,600. The child will gain control over this fund from age 18 but can't access it until much later (at least age 57 on current rules).

Passing it on

An up-to-date Will is important in making sure that your assets go where you want them to when you die. Depending on the expected size of your estate, you might also want to look at mitigating any IHT that your beneficiaries might have to pay on the estate you pass to them.

Between the existing nil rate band, the main residence nil rate band and the ability for married couples and civil partners to transfer unused nil rate bands between them, from April 2020, an estate could potentially pass on assets worth up to £1 million free of IHT.

You can give up to £3,000 worth of gifts away each tax year without it being liable to IHT. Similarly, you can pass on individual gifts worth up to £250 to as many people as you like in any one tax year, provided you've not gifted them through any other exemptions.

Don't forget about pension savings

While you are thinking about a Will, it's also worth checking that *Expression of Wish Forms* for any pension savings you have are up-to-date. Pension savings usually won't form part of your estate for IHT purposes. That's because the scheme trustees pay out to your beneficiaries at their discretion. The role of the *Expression of Wish* is to tell them what you would prefer to have happen.

SETTING PRIORITIES FOR THE REST

Once you have covered all the financial basics you need to, you can spend some time thinking about your longer-term plans. This concerns your goals and priorities, your ambitions and any future events you want to plan for with the help of your lump sum.

It can be hard to know where to start in visualising the future, so working with a professional financial planner or adviser can be particularly helpful in this.

These are some of the key questions you should ask yourself:

When would I like to retire?

The pensions landscape has undergone a dramatic overhaul in recent years and we can expect the changes to keep on coming. For instance, there's a decent chance that the rate at which the state pension age is increasing for both men and women will continue to accelerate. The result might be that your main long-term goal is to be able to retire when you want to, rather than be left at the mercy of legislation.

Do you have a particular age at which you want to retire, or does the idea of a phased or gradual retirement appeal to you? Your answer to that question will have an influence on your spending and investment plans, and on how you structure your broader finances.

How much can I expect from the State Pension?

If your State Pension Age is within a decade or so, consider getting a state pension forecast from the Pension Service (at **www.gov.uk/state-pension-statement**). The state pension for people reaching State Pension Age now is a flat payment, but 35 years of national insurance contributions (NICs) are required to qualify for the full amount.

If your NICs are short of where you need them to be, you could consider using some of your lump sum to top them up by making voluntary contributions. Details of how to do this can be found at **www.gov.uk/voluntary-national-insurance-contributions**.

Do I expect to move house?

Your spending and investment plans for your lump sum will be influenced by your mortgage situation too. Depending on any decisions you've made about using your lump sum now to help reduce or clear your mortgage it may help to set a target date for paying off the rest as part of your longer-term plan.

If you intend staying in your home for years to come, while you have the money you could also consider investing in it. That could be about improving your general living environment, like getting a new kitchen for example. Or it could be about making practical changes that could be helpful in future – for example moving a bedroom and bathroom downstairs to make your home more accessible as you get older.

And if you think you might need personal care in later years – either in your own home or by moving into a nursing home – you could set aside a designated sum toward the cost of this.

What type of lifestyle do I want?

Don't forget the more enjoyable possibilities. Whether it's a round-the-world trip or the holiday home you've always wanted, you'll want to think about how your lump sum could help bring you pleasure as well as greater security.

INVESTING FOR THE FUTURE

Once you've set your priorities, investing your lump sum wisely will help it make the biggest potential contribution to meeting your long-term needs and goals.

Check what you already have

It's sensible before embarking on any new investments to clarify what you already have in place. There's a good chance you'll have some money tied up in one or more workplace pensions, and perhaps a personal pension and ISAs as well.

A professional financial planner or adviser can help you get a clear picture of what your current investments are worth, and whether consolidating them in some way along with your lump sum might be a good move for you. For example if you are currently paying excessive charges or are in investments that are no longer suitable for you given your appetite for risk and personal circumstances and needs.

Make your plan of action

Once you understand the base from which you'll be investing your lump sum, exactly how you invest it will depend on factors such as how much you have to invest, your specific goals, how long it is before you'll want to start accessing your investments to meet those goals (for example to pay off your mortgage or help fund your retirement) and your appetite for taking risk with your money.

Reaching your goals

Our interactive tools can help you work out how much you need to invest to meet your goals and what you might expect to get back from those investments in future. You can find them at **alliancetrustsavings.co.uk/investing-hub/tools/**.

INVESTING FOR THE FUTURE (continued)

Follow the golden rule

Investments can go down as well as up and you can get back less than you put in. That is why diversification, or spreading your money across and within different asset classes to help manage your risks, is the golden rule of investing. There's a quick overview of some of the main asset classes below.

To help with diversification, many people choose to access investments through collective or pooled vehicles run by professional fund managers, such as Unit Trusts, Open-Ended Investment Companies (OEICs) and Investment Trusts.

The investment approaches used by the managers of Funds can vary widely, along with the range of asset classes, companies, industries, countries, regions and themes they can invest in.

The advantage of using Funds is that you can leave it to the experts to decide where best to invest your money. You should though have a view on the outcome you want as that can help you choose which Funds are most suitable.

For example, do you want your lump sum to be invested in a way that generates a regular income for you (whether that's for now, in retirement or both)? Or is growth your main priority, with a desire to make your lump sum go much further?

It doesn't have to be one or the other – a diversified portfolio or Fund will often contain both income and growth-oriented investments. And depending on your particular needs and priorities, reinvesting any income you do receive rather than taking it out is an option you can consider, to help make your lump sum go further still over the longer-term.

Cash

Cash savings don't go down as well as up like investments do. But they are not risk free. The main risk with cash savings is that the interest you are paid on them doesn't keep up with rising prices (inflation) over the longer term.

Shares

If you invest in shares (also known as equities) you become a joint owner of the company that issued them, along with the other shareholders. You share in the ups and downs of the company's fortunes, including any dividend payments it makes. Share prices in any company can change sharply and suddenly and this makes them a higher risk investment. Although returns are not guaranteed and prices can go down as well as up, shares can also bring higher returns over the longer term (10 years or more) compared to other types of investment.

Bonds

These are a type of loan where the investor is lending money to a corporate or government issuer in exchange for a fixed schedule of interest payments. Those issued by the UK government are known as Gilts. Bonds usually have a set life. And at the end of that life the original amount of the loan – the 'nominal value' – is usually paid back to whoever holds the bond at the time. This isn't always guaranteed though. Bonds are traded on the stock market so their price can go down and up. The return is a combination of interest received and any change in the bond's value.

Property

Collective investment vehicles hold either physical commercial property, such as offices and retail units, or invest in shares of property companies. The main advantage of property investing tends to be access to income but property can be prone to significant capital downturns and is vulnerable to properties being difficult to sell on. This can mean you may not always be able to sell investments in a property fund when you want to.

Be tax efficient where you can

When investing your lump sum, where you are eligible it also makes sense to take appropriate advantage of the various tax saving opportunities on offer. Here are some you might take into consideration. What is suitable for you will depend on your individual circumstances and appetite for risk.

Individual Savings Accounts (ISAs)

You can currently shelter up to £20,000 from both income and capital gains tax through ISAs. There are four main types of ISA and the allowance can be split between all of them if you wish. Stocks and shares ISAs are the main type used by investors.

If you've got more than £20,000 to invest and don't want to go down the pension route (see below) a common option is to invest the excess outside the ISA tax wrapper in something called an Investment Account. There are no limits to how much you can hold in an Investment Account, but you won't get any tax benefits.

Pensions

If you are happy to keep your money invested until you are at least 55, pensions have some very attractive tax advantages. Subject to an annual allowance and how much you earn, you'll get tax relief on what you pay in. For each £80 paid in by a basic rate taxpayer, the government adds another £20, while those paying tax at higher rates can potentially claim additional amounts through their self-assessment tax returns. Like ISAs, pension investments are sheltered from income and capital gains tax.

You can currently get pension tax relief on up to the greater of: all of your relevant UK earnings in the tax year, up to an annual allowance of £40,000; or £3,600 (before tax) regardless of any earnings. Reduced allowances apply for people who have started taking money out of a pension already, or who have an income of £150,000 or more. There's a lifetime allowance for pension saving too, currently set at £1.03 million.

There is a great deal of flexibility when it comes to taking money out of a pension and, provided you're within the lifetime allowance, you can usually take up to 25% out tax-free.

Investing in early stage businesses

Tax advantages are also available for those willing to invest in early stage, developing businesses. Venture Capital Trusts and Enterprise Investment Schemes are two ways you can do this. Be aware though that these types of investments are higher risk and are not suitable for most investors. You'll also need to commit to holding them for a certain period of time to qualify for the tax advantages.

Investment bonds

With investment bonds, you pay tax on gains and income within the bond, but this is capped at 20% and you can take up to 5% a year out for up to 20 years without incurring an additional tax charge at the time. This can make them a useful option for those who pay tax above the basic rate and are looking to manage their income tax bill. Any additional tax due is deferred until your bond matures or you cash it in.

GETTING A HELPING HAND

As you see, there's a lot to think about when it comes to making the most of a lump sum.

Working through all of this down to the level of individual decisions about where to put your money can be complex and is where using a professional Financial Planner or Adviser could be one of the best investments you make.

They can help you understand what you want to get out of your lump sum and help you navigate the various decisions you'll need to make, including finding suitable investment options, based on your circumstances, objectives, tax status and appetite for risk. Most will also help you keep your plan of action under regular review, making adjustments as needed over the years to keep things on track.

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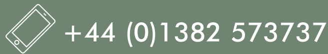

Lines are open 8am to 5pm Monday to Friday.
Calls may be recorded for training and monitoring purposes.

This information does not constitute investment advice or a personal recommendation for any particular investment and should not be used as the basis of any investment decision. If you are unsure you should consult a financial adviser before investing. The value of your investments and any income from them can go down as well as up and you may get back less than you originally invested. Tax treatment depends on individual circumstances and may be subject to change in the future. The information here is our understanding in September 2018.

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