FINANCIAL FOCUS

KEEPING YOU UP TO DATE WITH DEVELOPMENTS IN FINANCIAL PLANNING | AUTUMN 2005

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Rob Sandwith, Chief Executive

Welcome to the autumn edition of our newsletter.

At the time of writing, investment markets have performed well this year and remained resilient in the face of several challenges including the London terrorist attacks in July and the hurricane in New Orleans in August. Corporate results have generally surprised on the upside, with many companies reporting record profits. Investors have now seen returns of over 60% from the UK stock market since the lows of March 2003, a time when such investments felt very uncomfortable.

Sadly, terrorist events bring into focus our own mortality and the plans we have in place, not only for our families in the event of death, but our business partners too. The government has this year introduced trust rule changes, which potentially effect life assurance benefits. It is now sensible to review both levels of cover and how proceeds are treated in the event of death.

On a cheerier note, new investment opportunities abound and the next five months mark the last period to receive tax relief on investments of up to £200,000 in Venture Capital Trusts (VCTs). Higher rate taxpayers can purchase investments worth £200,000 for a cost of £120,000. Please contact us to review the latest schemes or request further information on any of the articles in this newsletter.

Right place, right time? – The investment challenge

A poll undertaken by the Association of Investment Companies in December 2004 revealed 72% of fund managers reckoned that the main indicator of performance – the FTSE 100 – would end 2005 at 5,000 or less. By the end of July the market had already risen to nearly 5,300.

Short-term predictions are extremely difficult to get right. Nevertheless, bar room pundits continue to talk about "market timing" – buying and selling investments at the right times. This is easy with hindsight, but almost impossible in reality.

To see why, look at the performance of UK shares over the 15 years to the end of 2004. If you had missed just the best 40 days, your average annual pre-tax return would have fallen from 8.6% to a loss of 0.5%.

If you really cannot bring yourself to invest at one fell swoop, feed your capital into the market over a period of six or 12 months. That way, you might just enjoy perfect timing with some of your money.

The value of shares and other investments can fluctuate and it is possible you might not get back a significant proportion of your investment. Past performance is not an indication of future performance.

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A-Day approaches: massive change in the world of pensions

On 6 April 2006, we will see a seismic change in the pensions world. It will be on that day, known as A-Day, that a single new set of rules for the taxation of pensions will take effect. The reform will be the most radical tax revision to affect pensions in living memory. What makes it different from all the earlier revisions to pension taxation is that the new regime will *replace*, rather than just *add to*, the existing complex tax rules for different types of pension schemes.

"...unless you transfer before A-Day, you could end up reducing your entitlement to tax-free cash..."

Ironically, the sweeping-away of today's pension rules has itself created a raft of highly-detailed legislation designed to smooth the path from old to new. These transitional rules, the end of the old regimes and the start of new planning opportunities, all mean it is vital for your pension arrangements to be reviewed ahead of A-Day.

Among the areas that you should consider are:

Protecting existing funds One of the core elements of the new regime is that there will be a lifetime allowance that will effectively set the maximum tax-efficient size of pension fund. Initially, this will be £1.5m, rising to £1.8m by 2010/11. Where the lifetime allowance is exceeded, there will be a tax penalty of up to 55% when benefits are drawn. If the value of your current pension benefits already exceeds the lifetime allowance or may do so in the future, there are two types of transitional protection to help protect you from the penalty. Although you will have until April 2009 to elect for protection, the rules are such that you need to make an initial decision before A-Day.

Transfers A-Day will introduce greater flexibility, both in terms of drawing benefits and investment options. However, you may not be able to take advantage of these improvements with your current pension provider if they choose not to make the necessary changes to their scheme rules. The reluctance to change is often driven by administrative reasons.

One way to sidestep the problem may be to transfer your pension to another provider that offers the features you need. However, unless you transfer before A-Day, you could end up reducing your entitlement to tax-free cash because, under the new regime, any transitional protection for lump sums is lost on individual transfer.

Borrowing *by* schemes From A-Day, the maximum that can be borrowed by a pension scheme is 50% of its net value. At present, different rules apply to different types of scheme, but most significantly, if you have a self -invested personal pension (SIPP), it can currently borrow up to 75% of the cost of purchasing a commercial property. So, if your SIPP is worth £150,000, you could buy a commercial property worth up to £600,000 (at least in theory and ignoring expenses). In contrast, from 6 April next year, the ceiling will more than halve to £225,000.

Borrowing *from* schemes Under the current rules, a small self-administered scheme (SSAS) can normally lend the sponsoring employer up to 50% of the fund value on an unsecured basis. The limit will not change, but all loans made from A-Day will have to be secured.

Timing of retirement If you are due to draw your pension benefits before A-Day, it may pay you to defer your retirement until the new rules take effect. This could mean more tax-free cash if you are a member of an occupational scheme, and greater flexibility about how you can draw your income.

Even though A-Day is six months away, the sooner your review begins, the better. Many pension scheme administrators are under intense pressure ahead of A-Day, which can mean delays in obtaining the information on which you will base your decisions.

Remember, tax rules are subject to future changes and the new pension rules are still evolving in certain areas.

How will you be affected by falling interest rates?

Savers have been hit by the Bank of England's decision in August to start cutting short-term interest rates, though it did not come as much of a surprise. The Bank had held the base rate at 4.75% for a year, over which time the housing market cooled and the economy had slowed down. Not so long ago, 4.75% would have been viewed as the low of an interest rate cycle, not the peak, but we are now firmly in an era of low rates.

Borrowers will welcome the cut, but if you rely on interest to provide your income, the move is bad news. Worse still, some of the leading deposit-takers had already cut rates to savers in anticipation of the base rate cut. Basic rate taxpayers receive barely enough interest from many savings accounts at current levels to cover the effects of inflation. If you are a higher-rate taxpayer, then even a deposit-account earning interest at base rate does not keep pace with inflation once the Chancellor has taken his slice.

However, if you are prepared to look beyond short-term deposits, there are still some attractive income investments to be found. Unlike deposits, which are secure, the value of shares and other investments can fluctuate and it is possible you might not get back a significant proportion of your investment. Past performance is not an indication of future performance and may not be repeated. Here are some examples of income-oriented investments:

- Recent good dividend growth has meant that the income yield from UK shares remains competitive with deposit rates, in spite of the rise in share prices over the last year. An investment in UK equity income funds could offer you a good income now with the potential for that income to grow in the long term. There should also be scope for long-term capital growth. Equally, income and capital values could fall.

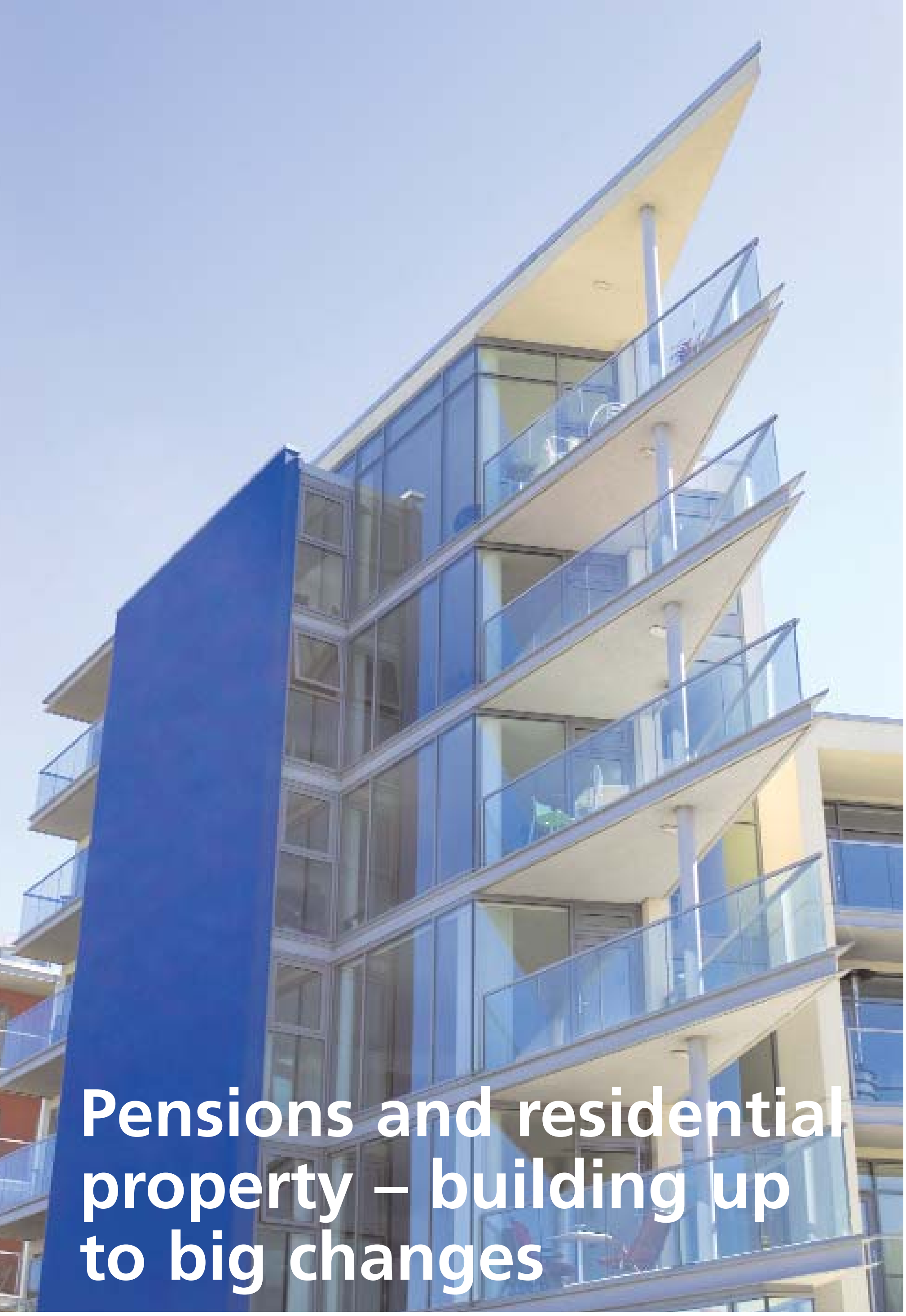
- If you are a higher-rate taxpayer, guaranteed income bonds can be worth investigating although you may have limited or no access to your capital before the bond matures. The tax rules for these bonds generally mean that all your income tax liability is deferred until maturity. Even then you only pay additional tax (at 20%) on the net payments you have received, whereas with a bank or building society deposit account, your extra tax is based on the gross interest.

- Although long-term interest rates have generally fallen over the last year, many corporate bond funds still offer higher income yields than deposit accounts, with the added advantage that interest payments are not linked to base rates. They do generally involve more risk. These funds are generally available for ISA and PEP investment, allowing you to receive your income free of UK tax. If you need monthly income, there is now a range of funds from which to choose.

The choice of investments for income is very wide, with the differences between products often hidden in the technical detail. Not all products and services are regulated by the FSA. It pays to take advice before making your selection; simply opting for the highest income on offer can be a costly error in the long run.

Remember, tax rules can change in the future.

"Basic rate taxpayers receive barely enough interest from many savings accounts at current levels to cover the effects of inflation."



Pensions and residential property – building up to big changes

Major revisions to the pension investment rules will take place next April, when the new simplified pension tax rules begin (see 'A-Day approaches: massive change in the world of pensions').

One of the most significant changes, at least to judge by the amount of press coverage it has received, is the removal of restrictions on residential property investment. The reform will mean that from 6 April 2006, you could invest in buy-to-let property through your self-invested personal pension (SIPP) or small self-administered scheme (SSAS).

Some pension experts – including one of the UK's largest life assurers – expect a surge of investors to put their pension funds into bricks and mortar. There have even been calls for the Chancellor to reverse the new law or face a £4 billion bill for tax relief (*Financial Times*, June 2005). So far, the Treasury has stood firm on its view that there will not be a wholesale rush of pension cash into residential property.

There are good reasons to think that the Treasury may be right on this score. For example, the issues you would face as a pension residential property investor include:

- **Investment strategy** If you own your home, you probably already have a substantial exposure to the residential property market. A buy-to-let investment through your pension would increase that exposure at just the time when most of the housing market is virtually stagnant. The Nationwide Building Society recently reported that annual house price inflation was at its lowest level for over nine years and said it expected “the path of house prices to continue to soften gently for some time”.

- **Buying power** The average value of an investment property in June 2005 was over £155,000, according to Paragon, a lender in the buy-to-let market. From April 2006, no more than half of a pension plan's net value may be borrowed for investment purposes. So you would need a pension fund of about £105,000 as a starting point to acquire just one average buy-to-let property, after purchase expenses are taken into account. And, of course, a single property hardly counts as a diversified investment portfolio.

- **Costs and control** Many owners of buy-to-let property undertake their administration and letting themselves. Agents' fees of 10% – 15% (plus VAT) are an obvious incentive to do so. But this might not be possible for property held in pension schemes. The pension trustees/administrators will be the legal owners of the property – not you. Health and safety regulations and the other obligations faced by property owners will almost certainly mean that the trustees/administrators will want professional agents to handle every aspect of the letting. For the same reason, pension providers are likely to be wary of student lets and properties where the rent is paid by the DWP.

For many people, a 'normal' pension plan, with a broad spread of professionally-managed investments, looks a more sensible choice than the buy-to-let pension. Nevertheless, there will be a few wealthy individuals for whom putting residential property into a pension makes sound financial sense. If you are interested in learning more about this new investment opportunity, your initial investigations should start now. Property purchase has never been the quickest of transactions and when you add in another party – the pension provider – the process can only slow down further.

Tax saving strategies for companies

Does your company have a financial year-end of 31 December? If it does, now is the time to start your year-end corporate planning. Leave your planning until December and the frenetic Christmas rush may make it harder to find the time in which to consider your options.

At least for 2005, the basic rules and rates for income tax and corporation tax are unchanged from last year. The mathematics of whether to draw a bonus or dividend from this year's profits – as shown in the table below – are thus the same as in 2004. Dividends are still the preferred route for small companies in the 19% corporation tax band.

The key change in 2005 concerns how to plan for the third and, arguably, most attractive option for removing profits – contributions to pension plans. The imminent arrival of the new pension tax rules on 6 April 2006 (See 'A-Day approaches: massive change in the world of pensions') means there are several new factors to be considered:

Maximising pension contributions If your fund already exceeds the new lifetime allowance (£1.5m in 2006/07) or is likely to do so before you retire, then this could be your last opportunity to add to your pension before claiming the new special protection after A-Day. Remember that any contributions made before A-Day must remain within current HMRC limits or post A-Day protection may not be granted.

Alternatively, you might want to boost your fund now to take advantage of privileges that disappear on A-Day, such as rules that still allow your self-invested personal pension to borrow large amounts to buy commercial property.

Increasing pay A large bonus payment might help you to obtain more tax-free cash after A-Day. If you are a member of an executive pension plan or small self-administered scheme, higher pay could mean more tax-free cash that is protected under the complex transitional rules. However, more pay implies more national insurance contributions and more income tax now.

Making no pension contribution Some people could be better off waiting to make pension contributions after A-Day.

Pension planning can be complex; the tax rules can change and investing in a pension generally involves tying up your money for the long term. The right decision will normally require detailed pension information and some careful number crunching – another reason to begin planning now.

Bonus or Dividend?

	Bonus £	Dividend £
Marginal gross profit	10,000	10,000
Corporation tax	N/A	(1,900)
Dividend	N/A	8,100
Employer's National Insurance Contributions (NICs) £8,865 @ 12.8%	(1,135)	N/A
Gross bonus	8,865	N/A
Director's NICs £8,865 @ 1%	(89)	N/A
Income tax	(3,546)	(2,025)
Net income to director	5,230	6,075

Assumptions:

- Company's marginal corporation tax rate 19%.
- Director's marginal income tax rate 40% (32.5% for dividends).
- The director's NIC assumes that other total earned income is at least £32,760.

Promoting pensions to your employees

Until recently, encouraging your employees to join a group personal pension plan (GPP) was a risky business for an employer. Some lawyers took the view that the financial services legislation meant that such employers could have been prosecuted as unauthorised advisers.

This strange state of affairs – which has never applied to occupational schemes – has now been put right by regulations introduced this summer.

As an employer, you now have a statutory exemption from the rigours of the Financial Services and Markets Act 2000 promotions rules when you tell your employees about a GPP, provided:

- You confirm that you, the employer, will contribute to the plan;
- Your business has not received any financial benefit from the plan and will not do so in the future;
- You tell your employees about the level of your contribution before they join the scheme; and
- You inform employees of their right to seek advice from an authorised source.

Shortly after the change came into force, the Department for Work and Pensions published guidance on the automatic enrolment of employees into GPPs. The guidance sets out how to avoid problems in such areas as data protection, money laundering and employment law.

The guidance does not have the force of law, but it should give you confidence to take a pro-active stance towards GPP membership, provided you are prepared to make some contribution – however small – to each employee's plan. In theory, this could mean that you can transform your existing employer-access stakeholder plan from an empty shell into a meaningful pension arrangement for your current and future employees.

In practice, employer promotion alone is unlikely to be enough. It is almost inevitable that employees will ask pension-related questions that require expert knowledge, not least in connection with their existing pension arrangements.

As part of our service to employers, we may be able to provide answers to such queries. You can also talk to us about other pension planning opportunities for your more senior employees.

Index-trackers hit oil slick

In July, Shell Oil and Royal Dutch Shell became a single company, listed on the London Stock Exchange. This meant that Shell became an even larger component of the stock market indices – with some curious side-effects. For example, immediately after the new company was created, FTSE 100 index tracking funds had to hold roughly a fifth of their investments in just two oil companies – Royal Dutch Shell and BP.

Don't forget 31 January

If you have not yet sent back your completed 2004/05 tax return, it is time to start getting your papers together. Every year, nearly one in ten people who receive tax returns fail to file them by the filing date (usually 31 January). There are probably few better ways of attracting the taxman's attention and it could cost you a £100 fine.

Tax planning is not regulated by the FSA.

Have you reviewed your business protection plans?

All shareholding directors in private companies or partners in partnerships should have some form of business protection assurance. This specialist cover is designed to help finance a change of ownership on the death (or serious illness) of a business owner. Without such an arrangement in place, the very continuity of a business could be threatened.

Most business protection has been set up as follows:

- You arrange life assurance and/or critical illness cover on your own life and place it in trust for the benefit of all the other shareholding directors/partners. They do the same.
- You all sign 'double option agreements' for the life assurance. This gives the surviving business owners the right to buy the business interest of the deceased from the executors and it gives the executors a corresponding right to sell.
- For critical illness cover, you give each insured director/partner who falls seriously ill an option to sell their interest in the business, but usually the surviving business owners do not have a right to buy.

HMRC has long accepted that such arrangements are purely commercial and outside the scope of inheritance tax (IHT), provided the trust beneficiaries are limited to the business owners. Unfortunately, there is no exemption from the government's latest measure to crack down on IHT avoidance schemes – pre-owned assets tax (POAT) – which came into effect in April this year.

"Without such an arrangement in place, the very continuity of a business could be threatened."

You should therefore arrange for a review of your business protection plan as a matter of urgency. Even if POAT proves not to be an issue, a review could still be worthwhile to consider the following:

- Is the current level of cover adequate? If your business has grown, so probably has its value.
- Could cover now be obtained at a more competitive cost?
- Have any changes in business ownership been reflected in the interests of the trust beneficiaries?
- Will it be possible to use pension-based life cover from 6 April 2006, giving you the advantage of full income tax relief on the premiums?

Exploring the benefits of offshore investment

Offshore investment has long been popular in the UK, mostly for tax reasons.

Successive Chancellors have removed many of the tax benefits, but some still remain. For example, income payments from most offshore funds are made without deduction of tax, so if you are a non-taxpayer, you do not have to go through the hassle of tax reclaim. Similarly, if you want to accumulate income in an offshore fund, you may be able to do so without paying any tax until the time you realise the investment (when you might not be a UK taxpayer). Of course, the tax rules could change again in the future.

Offshore funds can also provide you with types of investment that are hard to find within the UK.

For instance, if you wanted to invest in a euro denominated cash fund, there is plenty of choice offshore, but no such authorised unit trust or OEIC in the UK. The same is true of managed currency funds.

Until quite recently, many offshore fund providers were deterred from offering their funds here because of obstacles created by the UK's tax rules. However, a change introduced in the 2004 Budget has made it easier to launch offshore funds designed to suit UK tax rules.

The value of shares and other investments can fluctuate and it is possible you might not get back a significant proportion of your investment.

Time to take stock of with-profits investments

The last five years have not provided much good news for most with-profits policyholders. Bonus rates have fallen – in some cases to zero – while some well-known life assurance companies have closed their with-profits funds to new business.

Only 44 out of 110 with-profits funds were still open to new business in September 2004, according to a briefing by the Financial Services Authority (FSA) issued in that month. To make matters worse, many life companies rendered surrendering with-profits policies unattractive by offering low surrender values. This was frequently as a result of applying high market value reductions (MVRs). In the case of one major life office, Standard Life, surrender also means you give up a potential demutualisation bonus.

In their defence, the life companies were able to point out that investors in UK shares also had a tough time over the same period. In spite of the stock market rally that started in March 2003, by the end of July 2005 the main market index, the FTSE 100, still needed to rise by nearly a third to get back to where it stood at the beginning of 2000. It may be small comfort to you, but compared to many pure equity investments, with-profits returns are relatively less disappointing.

Fortunately, the with-profits scene seems to be stabilising in 2005. The FSA came to this conclusion in a review of the capital position of with-profits life offices published this summer. Improved investment conditions are also showing through, with MVRs being reduced or even eliminated. In some cases, there have been the first signs of an increase in bonus rates. The major insurers remaining in the market show no signs of wanting to leave, while a period of consolidation seems to be underway among the closed funds.

With the outlook clearer, now could be a good time to review any with-profits policies you hold. Contrary to some of the scare stories you might have read in the press, not every with-profits policy should be jettisoned as soon as possible. However, sorting the wheat from the chaff is not that simple, because even within the same company, some policies may be much less attractive than others.

You should seek independent financial advice before making any decisions.

"Contrary to some of the scare stories you might have read in the press, not every with-profits policy should be jettisoned as soon as possible."

The final year of low university tuition fees

Students starting university this autumn will be the last to avoid the higher tuition fees set to begin in the 2006/07 academic year. The only new students to avoid the higher annual fees (generally £3,000) next year will be those who are now taking a gap year.

The ethical option

There was a time when ethical investment was thought of as, at best, a minority interest for sandal-wearers and, at worst, a contradiction in terms. Those days have long since passed. Ethical investment is now part of the investment mainstream, thanks to government pressure, growing awareness of environmental issues and demand from institutional and private investors.

On the way to its current status, ethical investment has undergone something of a name change, so that it is now often referred to as socially responsible investment (SRI).

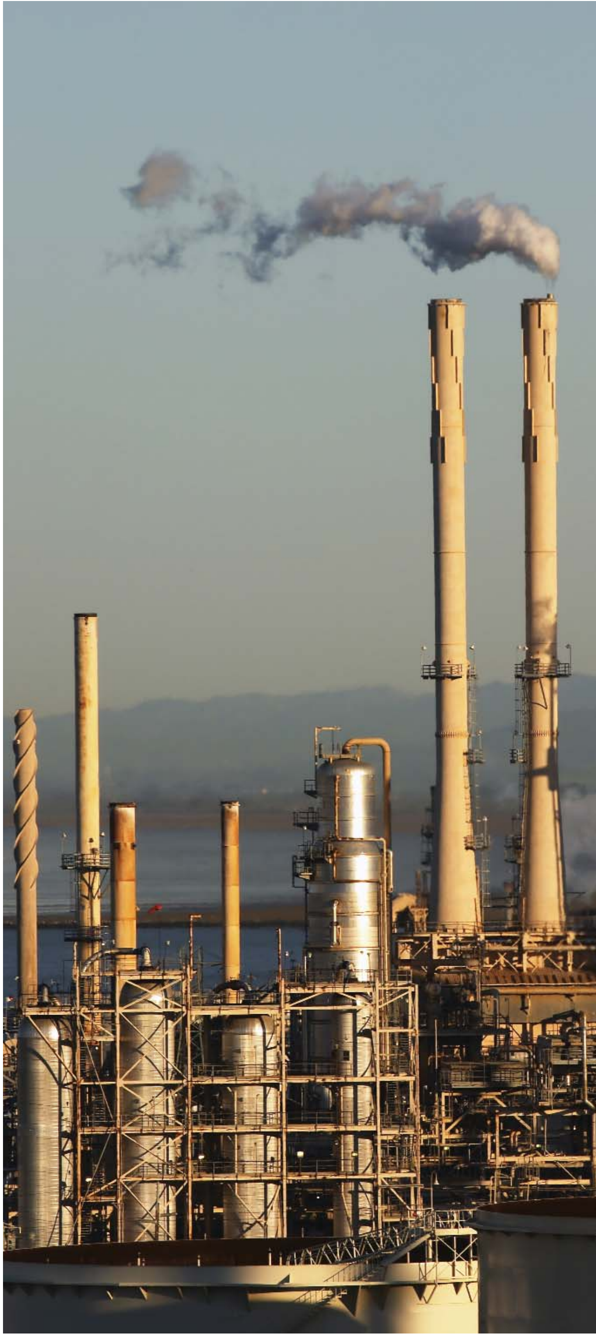
Research undertaken by Ethical Investment Research Service (EIRIS) puts the size of private investor SRI funds at over £5.5bn at the end of 2004, a nearly sevenfold growth over the previous 10 years. If you want to join the growing numbers of ethical investors, you now have a wide choice:

Unit trusts and Open-Ended Investment Companies (OEICs) Most of the major investment management groups offer at least one SRI fund and the Investment Management Association lists over 40 ethical funds. The majority of these funds are concentrated in the UK, but some have an overseas bias. Their diversity means there is no specific ethical fund sector, but there is a 20-member ethical sub-set of the largest single fund sector, UK All Companies.

“Ethical investment is now part of the investment mainstream...”

SRI funds are all eligible for investment through ISAs and PEPs, although some have a high minimum investment level, which makes them only suitable for plan transfers.

Life assurance funds You can invest in SRI funds through investment bonds and other life



assurance policies. Many of the life funds are 100% invested in the ethical unit trust or OEIC that shares the same name.

Pension funds As with life funds, many pension plans offer an ethical investment option through funds which invest in ethical unit trusts or OEICs.

Just as no two individuals' ethics are the same, so the ethical stances of funds vary. If there is a particular investment area that you want to avoid – such as animal research – make sure you take advice before investing.

Just because they are ethical or responsible does not necessarily make these funds any less risky. The value of these investments can fluctuate and it is possible you might not get back a significant proportion of your investment. Past performance is not an indication of future performance and may not be repeated.