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FINANCIAL REVIEW

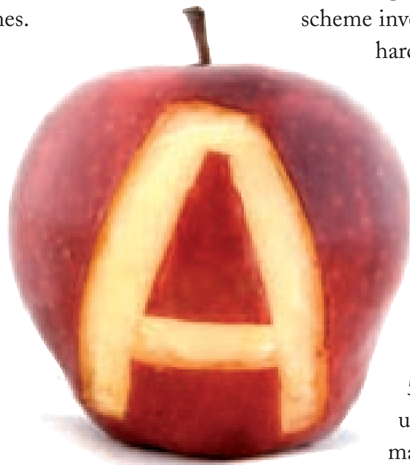
Autumn 2005

A-Day approaches:

massive change in the world of pensions

On 6 April 2006, we will see a seismic change in the pensions world. On that day, known as A-Day, a single new set of rules aimed at simplifying the taxation of pensions will take effect. The new regime will change the rules for all existing schemes and their members as well as new ones.

So it is vital for your pension arrangements to be reviewed ahead of A-Day. In particular you should think about:



■ **Protecting your existing funds** A new 'lifetime allowance' will effectively set the maximum tax-efficient size of a pension fund at £1.5m, rising to £1.8m by 2010/11. Exceeding the lifetime allowance could trigger heavy penalties. If it looks as if your pension fund will go over this allowance, you need to take urgent action before A-Day.

■ **Transfers** A-Day will introduce greater flexibility, both in terms of drawing benefits and your investment options. But you may miss out on these advantages if your current pension provider decides not to change their scheme rules – perhaps for administrative reasons. If you want to transfer to another more flexible pension provider, it could be best to do so before A-Day or you might affect your entitlement to tax-free cash.

■ **Borrowing *by* schemes** From A-Day, the maximum that can be borrowed by a personal pension scheme to buy commercial property will be substantially reduced. If you are depending on substantial loans to make your scheme's property purchase, you need to seek advice as a matter of urgency. You should remember though that, where a pension scheme invests in a property, it may be hard to sell the asset to generate the income in retirement.

■ **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. 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. Getting the information and making the plans can take time. Remember, tax rules are subject to future changes and the new pension rules are still evolving in certain areas. The Financial Services Authority (FSA) does not regulate most aspects of commercial mortgages.

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Right place, right time? – The investment challenge

"Prediction is very difficult, especially about the future," was the view of the scientist Niels Bohr, and this year has been especially tough for investment forecasting. For example, according to a poll undertaken by the Association of Investment Companies in December 2004, 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.

The fact is that relatively short-term predictions are very difficult to get right. Nevertheless, bar room pundits will continue to talk about "market timing" – buying and selling investments at exactly the right times. This is extremely easy to execute in hindsight, but almost impossible to achieve consistently in the real world.

One key reason why market timing is so hard is that markets can move sharply and unexpectedly. For instance, over the 15 years to the end of 2004, UK shares provided an average annual pre-tax return of 8.6%. However, if you had missed the best 40 days – that is less than three days a year – you would have lost 0.5% a year on average.

It is clear from this example that a major risk to long-term investment performance was missing out on some of these top-performing days by waiting to invest at the right moment. If you really cannot bring yourself to invest at one fell swoop, feed your capital into the market over a period of, say, 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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Review your business protection plans

All shareholding directors in private companies or partners in partnerships should consider having 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 critical illness cover on your own life and place it in trust for the benefit of all the other shareholding directors and 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.

HM Revenue & Customs 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.

You should therefore consider arranging 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?

WILL FALLING INTEREST RATES AFFECT YOU?

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 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, even a deposit-account earning interest at base rate does not keep pace with inflation once tax is taken.

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 many 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 could be worth investigating, although you may have limited or no access to your capital before the bond matures. The tax rules for these bonds currently mean that all your income tax liability is deferred until maturity. Even then you only pay additional tax (at 20%) on the net payments 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. The FSA does not regulate advice on deposit accounts. It pays to take advice before making your selection; simply opting for the highest income on offer could be a costly error in the long run.

Remember, tax rules can change in the future.

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 promotions rules of the Financial Services and Markets Act 2000 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.

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 page 1, '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, increased 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.

The FSA does not regulate tax advice.

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

Time to take stock of with-profits investments

The last five years have not provided much good news for most with-profits policy holders. 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 could be giving up a potential emutualisation 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. Past performance is not a guide to future performance.

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.

So now could be a good time to review any with-profits policies you hold. Contrary to some of the scare stories 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, as even within the same company, some policies may be much less attractive than others.

You should seek independent financial advice before making any decisions.

Sorting the wheat from the chaff

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.

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

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. Remember that currency values and exchange rates do fluctuate.

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. The FSA does not regulate some types of offshore investment.

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.

Please remember…

This newsletter is for general information only and is not intended to be advice to any specific person. You are recommended to seek competent professional advice before taking or refraining from taking any action on the basis of the contents of this publication. The newsletter represents our understanding of law and HM Revenue & Customs practice as at September 2005.

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 taking a gap year.

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.