

TAX-EFFICIENT INVESTMENTS

The purpose of this Memorandum is to describe some of the main investment opportunities currently available to individuals which offer tax advantages in certain circumstances.

This is not meant to be a comprehensive list, and it must be noted that some of the investments carry a degree of risk.

We are not specifically recommending any of these investments: it is important to check whether any investment is suitable in your particular circumstances before committing yourself.

SOME INVESTMENT OPPORTUNITIES

Individual Savings Accounts (ISAs)

These are formal arrangements which can be entered into with banks, building societies etc. You can invest up to £3,000 per annum in a cash 'mini' ISA, up to £3,000 in a stocks or shares mini ISA or up to £1,000 in a life assurance mini ISA.

Alternatively you can invest up to £7,000 per annum in a 'maxi' ISA. This has to include an element of stocks and shares, but can also include up to £3,000 in cash and up to £1,000 in life assurance.

You can only invest in one maxi ISA or 2 categories of mini ISA in any tax year.

Investments in ISA's are tax-efficient, since interest, dividends and capital gains are tax-free.

The cash mini ISA is particularly attractive for a top-rate taxpayer, since the interest is tax free, whereas it would otherwise be taxable at 40%.

It should be noted that you can hold a cash mini ISA with National Savings and Investments (NSI). This is 100% secure, as it is backed by HM Treasury.

Fixed interest savings certificates

These are also offered by NSI, and therefore offer total security. The interest rate is fixed from the date of investment until maturity, so you know from the outset how much interest you will earn.

At the time of writing there are two types of certificates available. One runs for 2 years, the other for 5 years. The interest rates are 3% and 3.05% respectively; the interest is not liable to Income Tax, and it is compounded, and only paid on redemption. There is no Capital Gains Tax.

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These certificates are attractive to higher-rate taxpayers. The effective gross rates of interest for a 40% taxpayer are 5% (2-year certificate) and 5.08% (5-year certificate). They are also attractive if you believe that interest rates generally are liable to fall or to remain static, since the rate on the certificates is guaranteed until redemption.

You can invest a total of £15,000 in each issue of savings certificates. It should be noted that there are penalties for early redemption.

Index-linked savings certificates

These are again issued by NSI and are similar to fixed-interest savings certificates. The maximum investment is £15,000 per issue but this does not count against any investment in fixed-interest savings certificates.

You can currently invest in 3-year and/or 5-year certificates. They carry a low rate of interest, which is added to the capital sum but the capital sum rises in line with the Retail Price Index. Both the increase in the capital sum and the interest are tax-free.

This investment is particularly attractive if you feel that inflation is likely to rise in the next few years, especially if you pay tax at 40%.

Again, there is a penalty if you cash these certificates early.

Premium Bonds

You may not immediately think of these as an investment, but they carry some interesting advantages.

First, the capital sum is totally secure.

The prize fund is based on the Government paying interest to the fund by reference to the total bonds in issue. The interest rate is 3.2% at present. A person who holds bonds over a long period is likely to receive a return by way of prizes which is broadly equivalent to the prevailing interest rate. This can be attractive to a 40% taxpayer, since it currently equates to a gross return of around 5.35%, although this will almost certainly be spread unevenly over the period of ownership.

There are no penalties for redemption.

It should also be borne in mind that there is always the possibility of winning the top prize of £1 million!

The prizes are, of course, free of both Income Tax and Capital Gains Tax.

The maximum holding is currently £30,000 per person.

Government Stocks ('gilt-edged')

These investments can be useful in certain circumstances, especially if you want to 'lock in' to a specific rate of interest for a period.

This can be helpful if for example a grandparent wants to give a lump sum to a grandchild and wants it to be invested until the child is 18 or 21. Currently, an investment in Treasury Stock 4.75% 2020 gives an overall yield of 4.43% gross and will be redeemed by the Government in 2020. The interest may well be tax-free in the child's hands, depending on the amount of the lump sum and whether the child has any other income.

Enterprise Investment Scheme ('EIS')

This is a method whereby you can obtain some attractive tax reliefs by investing in the shares of an unquoted trading company.

This is potentially a high-risk investment, since the success of your investment depends on the success of the company and also on being able to realise your investment in due course.

However, the tax advantages are very significant.

You can obtain Income Tax relief at up to 20% on your investment. The maximum permitted investment is £200,000 per tax year. You can also escape Capital Gains Tax if you sell the shares after 3 years.

In addition (or alternatively) you can 'shelter' a capital gain by investing in an EIS company. There is no monetary limit on this relief, but the tax liability on the original gain is deferred until disposal of the EIS investment, not eliminated. The proceeds of the original disposal must be invested in the EIS company within one year before the original disposal or three years after.

The EIS rules are very complex. For instance, the EIS company must be unquoted and it must be carrying on an eligible trade. The investment must also be a subscription for new shares, not a purchase of shares from an existing shareholder.

Venture Capital Trusts ('VCTs')

This is another risky investment, but the tax reliefs can be very attractive.

A VCT must be quoted and it must invest in unquoted trading companies. As with EIS companies, the rules are very complex. It is again important to note that the reliefs apply only if you subscribe for shares in the VCT, not if you buy them on the Stock Market.

For the year ending 5 April 2006, you can obtain Income Tax relief at up to 40% (depending on your tax position) by subscribing for shares in a VCT. You cannot obtain relief in a tax year on an investment above £200,000.

If you receive a dividend in respect of your investment in a VCT, this dividend is tax-free in your hands.

The other tax reliefs are withdrawn if you dispose of the shares within three years of subscription.

If you dispose of a qualifying holding more than three years after subscription, any gain on disposal will be tax-free.

Pensions

In many ways, contributing to a pension scheme is the ultimate tax-efficient investment.

This is because you will obtain Income Tax relief (at up to 40%) on your contribution. Also, the pension fund does not have to pay income tax, corporation tax or capital gains tax on its investment income and gains.

It must be borne in mind that there are laid down limits on the amount which you can contribute to a pension scheme. However, it is possible for anyone (including a child) to contribute up to £3,600 per annum to a pension scheme even if they do not have any earnings. Tax relief at 22% is granted in this connection, even to people who do not pay tax.

In addition, it should be borne in mind that the 'success' of your investment in the pension scheme is largely out of your hands, and is heavily dependent on external factors, such as the state of the Stock Market and Government intervention.

Depending on your circumstances, you may wish to consider making use of a 'Small Self-administered Scheme (SSAS) or a 'Self-invested Pension Scheme (SIPP).

Both are highly tax-efficient and are tailor-made for higher net worth individuals who are self-employed (including partners) or controlling directors of a family company.

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In the case of a SSAS, the contributors are allowed to be trustees and to administer the investment policy within certain parameters. In the case of a family company, the fund can lend money to the business, it can also buy the company's business premises and lease them back to the company. This kind of transaction has to take place on commercial terms.

Income and gains in a SSAS are tax-exempt.

Similar considerations apply to a SIPP, although at present the investment restrictions for a SIPP are tighter than those for a SSAS. For instance, a SIPP cannot acquire a property from a member's business; however, it can acquire a property from an outsider and then lease it to a member's business (at market rental).

Although the pension rules are already beneficial, further improvements will be introduced from 6 April 2006. This is a vast subject, so please let us know if you would like detailed information.

FOR GENERAL INFORMATION ONLY

Please note that this Memorandum is not intended to give specific technical or investment advice, and it should not be construed as doing so. It is designed to alert clients to some of the opportunities available and the issues to be considered. It is not intended to give exhaustive coverage of the topic.

Professional advice should always be sought before action is either taken or refrained from as a result of information contained herein.

Detailed and up-to-date information on National Savings products can be obtained from the following website: www.nsandi.com.