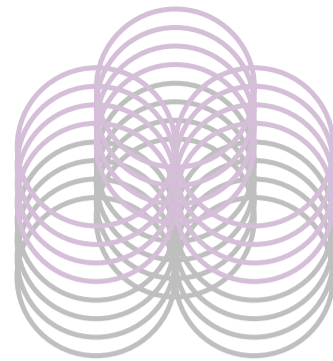
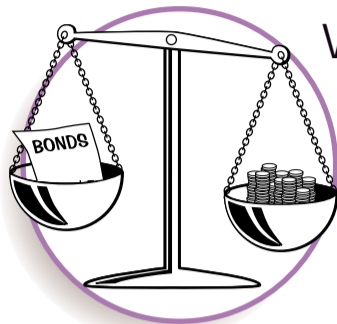


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WINTER 1997/98

ISSUE 2

ALAN STEEL ASSET MANAGEMENT

INDEPENDENT FINANCIAL ADVISERS

Are the experts right?

In 1981 a recognised stock market guru of the time, Bob Beckman, wrote a book called *Downwave*. In it he predicted financial chaos in the West, particularly the UK. He advised property owners to sell property, share owners to sell shares, and to re-invest everything in deposits.

He was horribly wrong. Domestic house prices continued to rise strongly until the end of the decade and the FT All Share Index rose tenfold in the next 15 years, with gross income reinvested, despite the share crash of October 1987.

In July 1996 the newspaper headlines predicted a free-fall in UK share prices when the FT 100 Index was averaging around 3700. In a Scotsman article at the time we argued the opposite. In the spring of this year quality national newspapers claimed experts saw a major stock market crash if Labour won the

Election. The market rose. In October television news programmes were talking about the biggest one day fall the FT100 Index has ever suffered. In fact the largest percentage fall in any one day over the month was 3%.

When we stand back and take



over 25% and was standing at over 4800.

In the last few years we have continually argued that there is substantial value in the world stock markets. We have also pointed out that traditional growth areas such as small and medium sized companies offer excellent long term opportunities. The indices that measure the share performance of these areas show that, since the start of the year, they have not risen.

This represents tremendous value. We are convinced that well chosen, well managed equity funds will continue to offer excellent returns.

In saying all of this we are very much aware that there is turbulence in the markets at the present time - as there has been many times before. However, as long term investors, we would rather get to our destination than don parachutes and jump off the plane in the middle of nowhere.

stock it is clear that investing in Britain's major companies over this time would have been very satisfying. From July 1996 to the middle of November 1997 the FT100 Index had risen by

Pensions - life after Brown?

A survey earlier this year showed that almost half of employed people in the south were relying on building society deposits as their main savings to plan for eventual retirement.

How wrong can they be? To put it into perspective, if a 40 year old wants to retire at age 60 with an income in today's money of £20,000 per annum, assuming 3% inflation and 5% investment return, he or she would have to invest, after tax, over £18,500 each year to achieve their aim.

If on the other hand they tried to achieve the same result using a pension plan, obtaining 12% per annum growth, (not unreasonable) a high rate taxpayer would only have to invest £4818 each year, after tax relief.

But pensions have had a bad press over the last few years. We are told the charges are too high despite the fact they are about the same as unit

trusts which generally get a good press. Then of course there's the mis-selling scandals which actually affected a minority of the public. Finally pensions have suffered from the headlines following Brown's summer Budget.

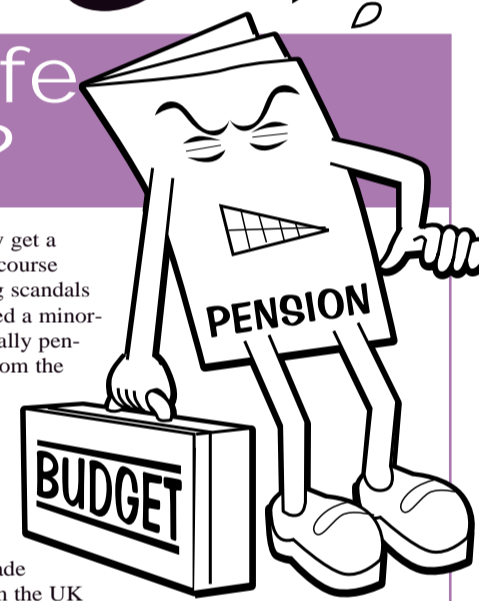
I'm certain you saw the headlines too. But what actually happened? Mr Brown has merely made dividends earned from the UK shares inside a pension plan liable to a small tax charge, roughly equivalent to the tax on deposit interest for a basic rate taxpayer. For people investing in mixed pension funds the impact is minimal.

What's the good news? You can still have full tax relief on contributions, growth is still tax free, some income rolling up is less effective, but the tax free cash facility and the inheritance tax freedom are still in place.

But if you would like a pen-

sion plan which is unaffected by his changes you can have one. Further more this plan allows you to decide on the level of protection you would like if the Stock Market falls. You can even set the plan up, tax free, with no possibility of loss should the Stock Market fall, whenever that happens.

Pensions are still the core investment to plan for future income in retirement. Headlines sell newspapers, do not be put off by them.



Take an average retired couple, state pension, modest company or private pension, who own their own home, they have a number of investment arrangements which are invested for growth and they do not need to take any more income. They want to make sure that the children and grandchildren do not lose out through inheritance tax when they die.

Not to worry, the value of the estate is less than the nil rate band (£215,000). No tax to pay.

True, but what about survival? Ever heard of the Care in the Community Act? Unfortunately there is no nil rate band, no exemptions, no potentially exempt transfers. Indeed there is very little you can do to reduce the value of

your estate to avoid the impact of long term care costs. Under current legislation even the family home is up for grabs.

Of course, for those individuals with net income of £18,000 or couples with net income of £36,000 (the average cost of long term care in the UK) they should not be concerned unless they wish to have a degree of choice as to where they receive the residential care. Costs can then soar to £30,000 a year per person.

It is a fact, through lifestyle and medical science, that we are living longer and longer. Unfortunately the activities of daily living that we take for granted become more and more difficult to undertake and for many assistance in the home

Family wealth - going, going, gone



usually ends up with residential care.

For the family it can be an emotional and traumatic experience to go through, together with the slow realisation in many cases the costs have to be subsidised by using capital. Bear in mind that full state assistance to meet these costs will only become available when your assets are reduced to £10,000 in value.

So, while you plan to reduce the effects of inheritance tax it is important to assess the likely effects of nurs-

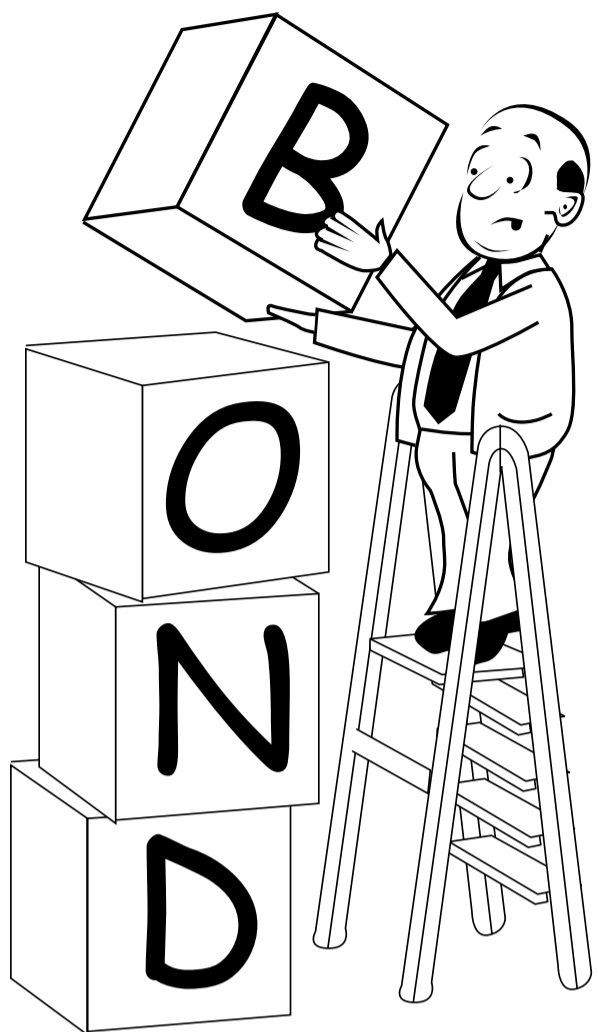
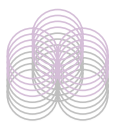
ing home fees on your capital, should you survive.

Bear also in mind that income tax and capital gains tax are levied at a rate of up to 40%. Inheritance tax is levied at 40% and in many cases can be classed as a voluntary tax. Care costs can be likened to a rate of tax of 100%, with a personal allowance of £10,000.

By careful planning the assets can protect themselves against inflation and erosion. If you fall into the category discussed here or are concerned in any way about long term care ask the questions now, not when it is too late.

SECURING YOUR FUTURE

Alan Steel Asset Management Tel (01506) 842365, Fax (01506) 845074



Investment bonds – an introduction

What is the tax position?

One of the most popular lump sum investments over the last 30 years has been the investment bond. Apparently there are around 40 million of them in force today. Yet our experience of them suggests that most owners of these investments do not understand the tax treatment, how they can be more effective, or how to compare investment performances against other funds or against other investments.

Most investment bonds have been sold by financial services' salesmen, the majority of whom do not understand the tax implications. What is clear however is that initial commission available on investment bonds can be as much as twice as high as commission available on other financial products that may be more suitable. While many independent financial advisers do not take the higher rates of commission offered, it is clear from our research that this is not the case from those representing individual insurance companies, banks, building societies, and those representing national brokers.

The last 10 years or so have seen unprecedented rises in people moving into early retirement and many of them have bought or have been sold investment bonds, rather than other suitable products, to provide income and growth over the years ahead.

As interest rates fell heavily from late 1992 onwards insurance companies took the opportunity to develop alternative products to sell to those concerned about falling interest rates. Thus "with profit" bonds were developed, designed around investment bond structures, and we fear that the performance of these products could be poor, especially coupled with the tax consequences for the unwary.

Finally the Inland Revenue have threatened changes to the taxation of investment bonds. However we do not consider that such changes can be retrospective.

These factors show there can be little doubt that an opportunity does exist now to restructure bond investments to improve your chances of avoiding future taxation.

As with other areas of insurance investment bonds are unfortunately beset by jargon. Indeed reading and understanding the small print regarding the taxation of bonds in any policy document requires a degree of mathematics and the patience of Job. Unfortunately too many people have been advised to invest in bonds without being made aware of the tax consequences. In this section we attempt to simplify this.

The Inland Revenue regard any investment bond as a single premium or lump sum insurance policy. This means any encashment, or partial encashment in excess of 5% of the initial investment will in normal circumstances create what is known as a "chargeable event." Importantly, death creates a chargeable event.

The underlying funds in investment bonds with UK based insurance companies have already had income tax and a reduced level of capital gains tax deducted. Therefore basic rate or non taxpayers would not normally have to pay additional tax on a chargeable event occurring as, in effect, tax has already been paid on their behalf.

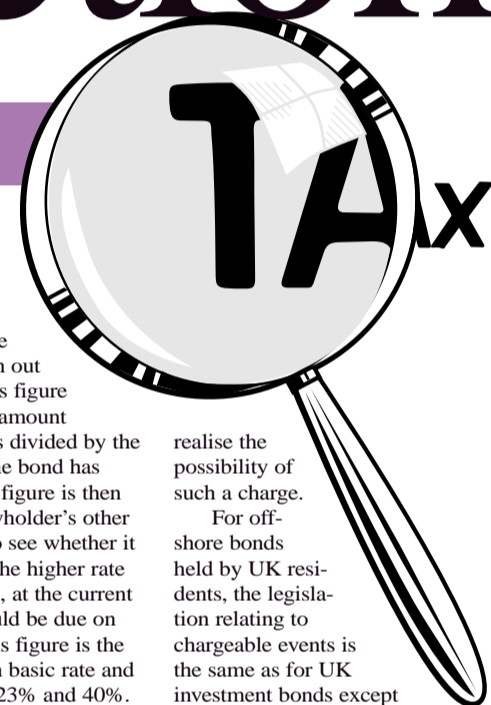
However higher rate taxpayers or those whose income levels are quite near the higher rate band may be liable to tax in the event of a chargeable event. This is why it is important that, in the case of a husband and wife making a joint investment into a bond, if there is a difference in the income tax rates between them, the bond should be owned for tax purposes by the lower rate taxpayer.

Calculating the tax due is fairly complicated but in general,

when a bond is encashed, its value at that time plus any withdrawals made since the bond was taken out is calculated. If this figure is in excess of the amount invested the gain is divided by the number of years the bond has been held and this figure is then added to the policyholder's other income received to see whether it pushed them into the higher rate tax band. If it does, at the current time, 17% tax would be due on the gain made. This figure is the difference between basic rate and higher rate tax, ie 23% and 40%. Over 20 years ago the maximum difference was 53%. In future, if basic rate becomes 20% and the highest rate tax 50%, then the chargeable event would create a potential charge of 30% at the highest level. Investors must

realise the possibility of such a charge.

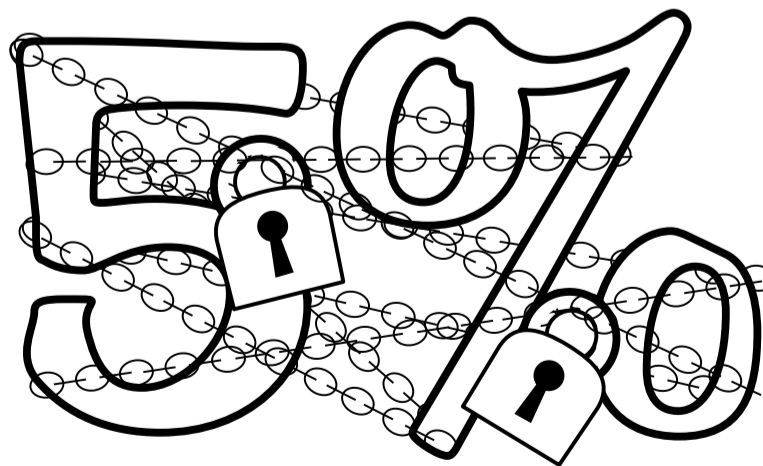
For off-shore bonds held by UK residents, the legislation relating to chargeable events is the same as for UK investment bonds except that, as the underlying fund in an off-shore bond is free of tax and no tax has been paid on behalf of the bond holder, both basic rate and higher rate taxpayers would suffer a tax charge in the event of a chargeable event.



Aren't the 5% annual withdrawals free?

No. There is clearly much confusion about the 5% withdrawals. In the case of a bond from a UK based insurance company tax is being paid internally, as we have explained, on behalf of the policy holder

The rule that applies as far as withdrawals are concerned is that the Inland Revenue allow up to 5% of the original investment to be withdrawn each year without creating a chargeable event. These withdrawals are cumulative and therefore if no withdrawals have been made from a bond invested five years ago, it would be possible to take up to 25% (5x5%) of the amount invested without triggering a potential tax charge. Withdrawals within these limits can continue until 100% of the amount invested has been taken. Therefore this has been translated into 20 years at 5% annual



withdrawal rate. But it is not tax free.

As we have explained, on encashment, withdrawals made are added to the value of the bond and an extra income tax charge will be levied if the investor is a higher rate taxpayer at the time. Therefore the with-

drawals are in effect tax deferred and can lead to a hefty tax charge in the future.

Example:-
Mr A takes out a bond for £20,000, takes £1,000 per annum withdrawals for 20 years and cashes the bond for £40,000 when he is a higher rate taxpayer

er. The profit is £20,000 plus the income taken (10x £1,000 which is another £10,000.) The total taxable profit is therefore £30,000 and the extra tax due is £5,100. This could also happen on the death of Mr A.

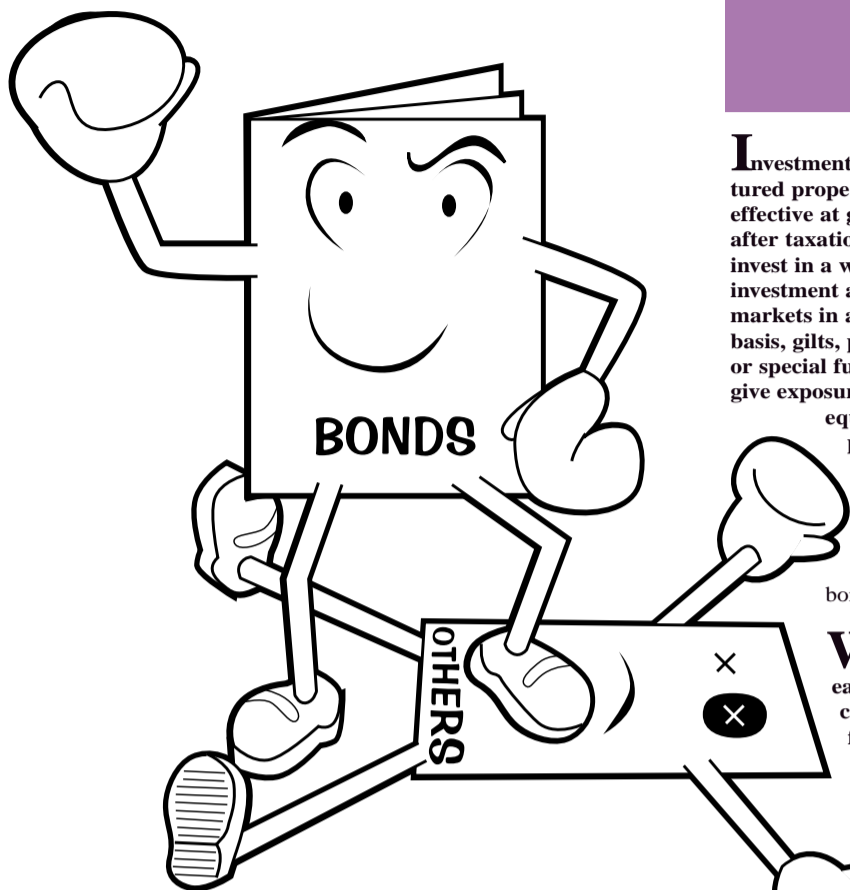
For off-shore bonds the 5% rule still applies and if the bond is encashed all of the withdrawals plus the profit is added to the investor's income, as before) but without any allowance for basic rate tax.

Unless off-shore bonds are drawn up with care to minimise or eradicate such a tax charge then all of the profit plus all of the withdrawals can be liable to the rate of tax paid by the policy holder in the year of encashment.

That is why investment bonds, especially off-shore bonds, should be structured to minimise future taxation.



How do bonds compare with similar investments?



Investment bonds if structured properly can be very effective at giving good returns after taxation. They can also invest in a wide variety of investment areas such as equity markets in a general or specific basis, gilts, property, deposits, or special funds designed to give exposure to the growth in equity markets while protecting against down-side loss.

This is important as the holder of the bond can switch within the bond structure from

We have mentioned earlier that bonds, if correctly structured for individual circumstances, can be extremely effective in controlling taxation.

This sadly does not explain why so many are sold at the exclusion of

other collective investment products and why most bonds are not structured with care.

What is certain is that the majority of bonds purchased provide more initial commission to the salesman. If bonds are recommended by sales people representing insurance companies, banks or national brokers, whether we are referring to off-shore or UK based bonds, the chances are that the initial commission payable can be as high as 7% of the initial investment.

Until relatively recently direct selling organisations had no requirement to advise the purchaser of the level of commission payable on the sale of the product. This has now been changed. The information should be made available to the purchaser, usually contained in Key Features or Product Particulars, before the sale.

However the initial commis-

sion on other investment products such as Peps, unit trusts and investment trusts is usually at the level of 3%, about half the amount. It should be noted that when people buy and sell equities the total charge is normally about 3% also. We believe that the level of commission charged by any salesman should be the same, irrespective of the type of investment, and should be reinvested to enhance the investment. This would remove any potential bias from the recommendation.

Indeed, for large investments the initial commission should be greatly reduced. Off-shore bonds tend to have higher initial costs because, unlike UK equivalents, off-shore insurance companies tend to make extra charges over and above the commission payable for some reason best known to themselves. In this situation, bearing in mind the fact that somewhat larger amounts are invested in off-shore bonds because of the potential tax benefits, the investors should request that the sales people reduce their entitlement to commission to counter the extra initial costs applied by the insurance companies.

Annual management charges of most bonds are similar to other collective investments. We believe it is the case that most bond investors receive little

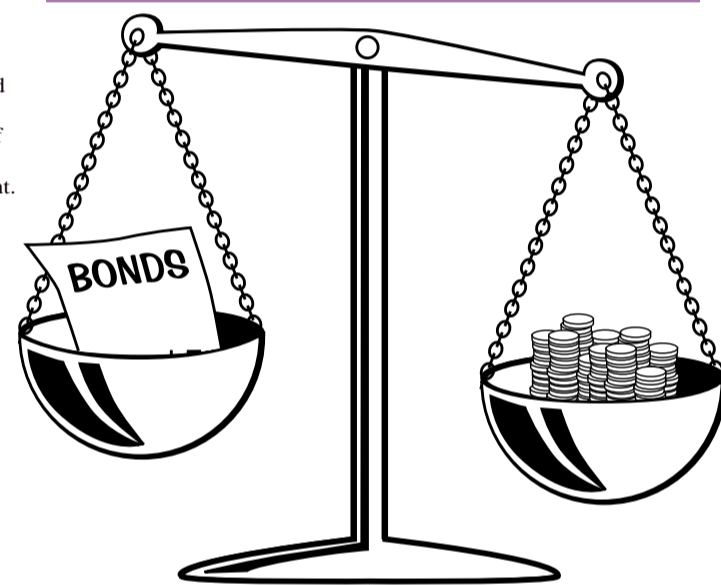
to move back into equities from deposit they will incur fresh initial charges. The bond investor would, of course, be able to switch back into equity linked funds free or at extremely low cost.

With the exception of Personal Equity Plans, other investments providing income at any level lead to extra income taxation for higher rate taxpayers. Furthermore, Peps as well as unit or investment trusts must be held as part of the investor's estate on death thus possibly providing less tax efficient investment returns for beneficia-

ries. Investment bonds however can, if properly set up, be a far more tax efficient investment.

Bonds do offer innumerable advantages if correctly used for a wide range of circumstances, such as where they are issued on more than one life, where they are subject to a trust, or by assisting in reducing the administration burden brought on by self assessment. In particular off-shore bonds, under present law, can give enormous advantages in the avoidance of all personal taxes if issued under suitable trusts and structured correctly.

Charges and commissions



if any service from sales organisations after the bond is purchased. It is common for investors to be left entirely on their own after a sale has been completed. This is clearly not in the investor's interests and is hardly fair. Normally, from the annual management charge, a fee is paid to the advisers. This is made to encourage advisers to give a regular service over the

years after the bond is purchased. It is our practice to provide simple, straightforward valuation services on a six monthly or annual basis after a bond is purchased and to make ourselves available to clients to discuss performance, continued tax planning opportunities, or amendments that should be made given market circumstances.

How to minimise taxation bonds



If you have UK based bonds in place now, and are married, it may be worthwhile transferring the bond ownership to the partner with the lower income. This is achieved by assigning the bond. The new owner can subsequently encash the bond without an extra tax charge as long as the proceeds are taken by the spouse whose total income is within the basic rate tax band.

It is likely that tax-free assignments between spouses will be abolished in the near future. Therefore, anyone in the above situation would be well advised to take advantage of this facility as soon as possible.

When purchasing new bonds, married couples should ensure that, if there is a difference in income tax rates, the bond is owned by the lower taxpayer. This can be done even if there are two lives assured. Also, the bonds should be set up on a second death basis, thus deferring any potential tax liability as long as possible.

Off-shore bonds have the added advantage that not only spouses can be lives assured but also children and grandchildren. This is extremely useful as it makes it possible for the bond to be passed down to future generations. This coupled with the use of trusts can make off-shore investment bonds an extremely efficient way to minimise tax, both during your lifetime and on death.

With profit bonds – or are they?

There is little doubt that a large proportion of investors are continually concerned about risk. That is why such a large number of people hold substantial funds in deposit with banks and building societies despite the poor returns. Prior to late 1992, most risk averse investors, even higher rate taxpayers who suffer even lower returns after tax, held large deposits attracted by gross returns of over 10% per annum. After tax and inflation the real returns were probably nil or even worse.

When interest rates fell sharply, these investors, especially if requiring income, looked for what they thought to be suitable alternatives. Thus, the With Profit Bond was developed by astute marketing people. It appears that at least a few million such bonds have been purchased. But are they effective?

In the later part of the last century, insurance companies developed With Profit policies to give policy holders better returns on, for example, endowment policies. However these policies bear no relation to With Profit bonds. For example, once bonuses were added to traditional With Profit policies, they were guaranteed and could not be taken away. With Profit bonds, on the other hand, reserve the right to remove bonuses added with what is called a market adjustment factor. This can be applied to reduce

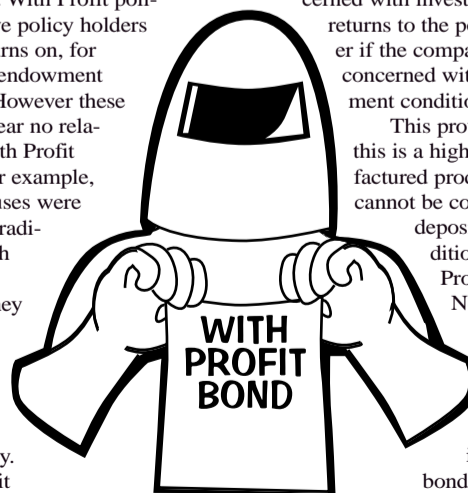
the investment returns to the policy holder if the company are concerned with investment returns to the policy holder if the company are concerned with investment conditions.

This proves that this is a highly manufactured product which cannot be compared to deposits or traditional With Profit plans. Nor can it be easily compared to other investment bond funds where no discretion about investment returns is possible.

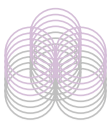
These factors, added to the high initial charges and the fact

that most investors are receiving income from their bonds, often as high as 7.5% per annum, suggests that some With Profit investment bonds will turn out to be poor investments. We have seen total bonuses being declared recently of less than 7% and, when you consider the drawbacks, we would be very surprised if good growth has been achieved over the last five years or less using these products.

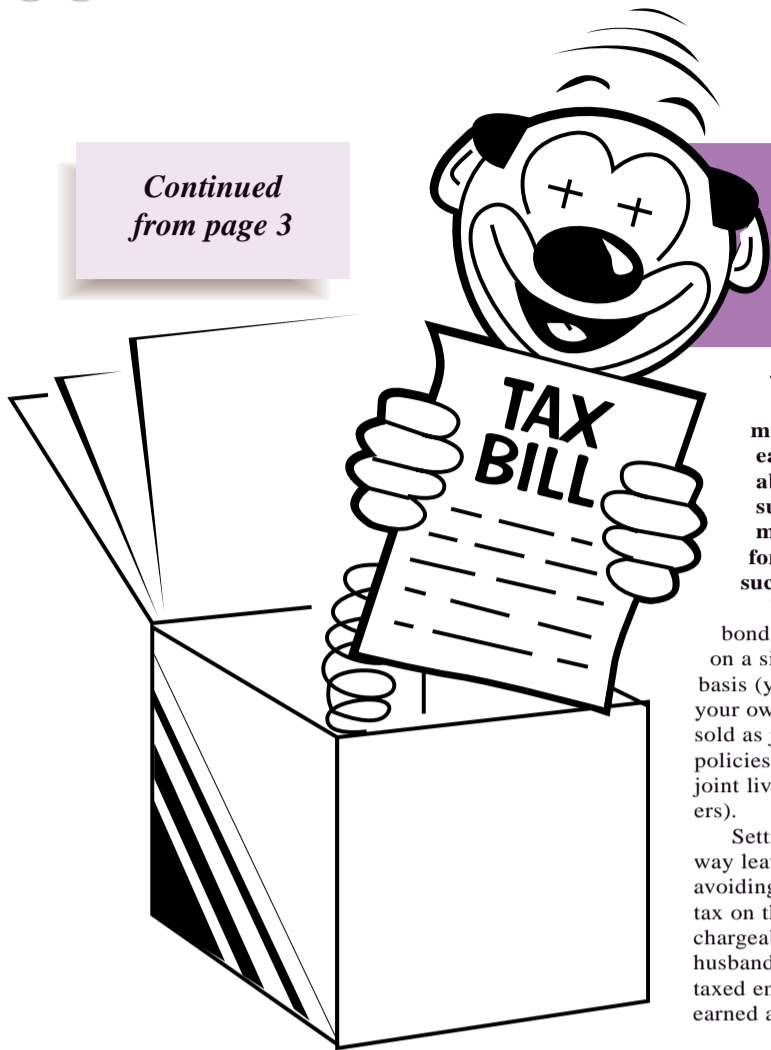
Although they can be useful as part of an investor's overall portfolio, we are in no doubt that they have been over-sold and, as such, they should be purchased with caution.



Continued overleaf



Continued from page 3



How bonds are normally set up

You have to bear in mind, as explained earlier, that chargeable events can create surprise tax bills. It makes sense, therefore, to try to avoid such surprises.

Usually investment bonds will be sold either on a single life single owner basis (you take out one on your own life) or they are sold as joint life joint owner policies (married couple as joint lives assured joint owners).

Setting up bonds in this way leaves little scope for avoiding or controlling extra tax on the occasion of a chargeable event. Since 1990, husbands and wives have been taxed entirely separately on earned and unearned income.

This is called Independent Taxation. Too many investment bonds do not take account of the tax planning opportunities available under Independent Taxation. A chargeable event, in the case of a UK based bond, for a high rate taxpayer creates an extra tax charge. It makes good sense, therefore, to plan that the person on whom the chargeable event falls is, at worst, a basic rate taxpayer.

Also, as explained earlier, death creates a chargeable event. Therefore, it makes sense to ensure that, in the case of a joint life policy, the bond continues until the second to die. However, in our experience, a number of bonds have been set up on a first death basis, thereby creating an unwelcome, and indeed unnecessary, tax liability.

Why invest off-shore?

As we said earlier, there are normally extra costs involved in investing in off-shore Bonds, as well as potentially greater tax liabilities in the event of a chargeable event. Given these factors, why should anyone consider investing off-shore?

The main reason is that off-shore Bonds can have significant advantages over on-shore Bonds in mitigating income tax, capital gains tax and, with careful use of trusts, inheritance tax. How is this possible?

As described earlier, death is classed as a Chargeable Event under tax legislation. With UK Investment Bonds, it is only possible for a husband and wife to

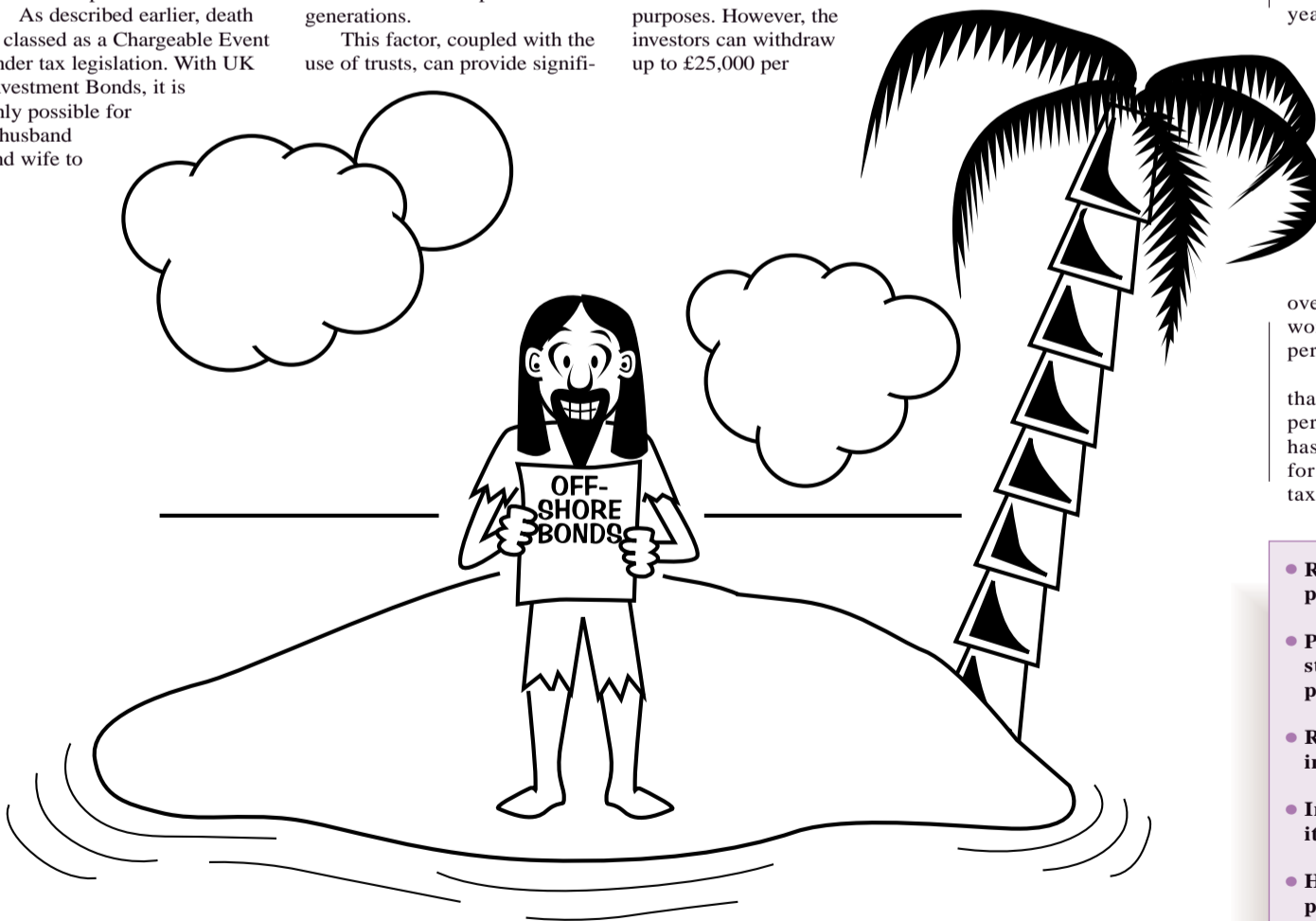
take a bond out on a joint life basis which, therefore, defers the tax charge to the second death. However, with an off-shore Bond, it is possible to include not only a husband and wife, but also children, grandchildren or, indeed, any other person as a Life Assured. By setting up the off-shore Bond on a multiple life basis and ensuring that the chargeable event does not occur till the last death, it can, in many cases, be possible for the Bond to pass down generations.

This factor, coupled with the use of trusts, can provide significant

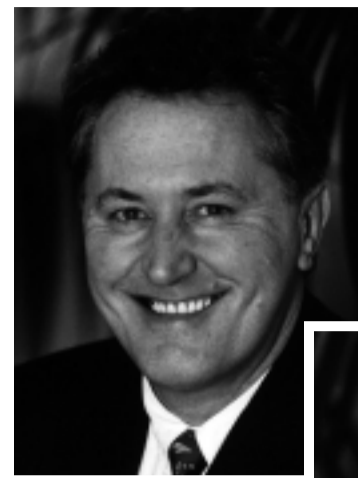
tax advantages, both while the investor is alive and after their death. Indeed, one of the leading off-shore insurance companies have devised a plan which allows the investors to gift money out of their estate while, at the same time, giving the investors access to their capital. For example, a couple invests £500,000 into a plan of this type. If they survive a further seven years, the investment is outwith their estate and has no value for inheritance tax purposes. However, the investors can withdraw up to £25,000 per

annum (5%) without any liability to tax. This plan is based on current tax legislation and, if the tax charges proposed take place, may not be available in the future.

Such plans are obviously not suitable for everyone. However, they are an example of some of the advantages that investing off-shore offers and how, with careful planning, the extra costs involved with investments of this type can be worthwhile.



Alan Steel Asset Management is regulated by the Personal Investment Authority. Please remember that the value of your investment and the income from it can go down, as well as up, and you may not get back the amount you originally invested. Past performance is not necessarily a guide to future performance. The information in this newsletter is based on our understanding of current UK tax legislation which may be changed in the near future.



Who are we?



Some of the key players (clockwise from top left): Alan Steel, who leads the team; Ken Wilson, who is responsible for investment strategies; and Stan Chuchla, who has 26 years' experience in personal finance.

Alan Steel Asset Management was formed in 1975. We are based in the small town of Linlithgow in the middle of Scotland, but most of our clients are elsewhere, including a growing number from various parts of England.

Twenty two years ago there were only two of us. Gradual increases over the years see us now with 30 staff, most of whom provide client support and service.

There are now seven key advisers, including full time directors. Alan Steel, an independent adviser for more than 24 years, leads the team. He specialises in overall financial planning and working closely with national personal finance journalists.

Stan Chuchla has more than 26 years' experience in personal finance. Ken Wilson has special responsibilities for investment strategies. Our tax planning section is

headed by Frances Sinclair, a Chartered Accountant and Associate of the Institute of Taxation.

Steve Forbes, who joined us three years ago, brought with him wide financial planning expertise, including off-shore tax planning. Graeme Currie and, more recently, Alex MacLean have joined the team, bringing further expertise gained with national firms of employee benefit consultants.

Our role as independent advisers, supported by our service staff, is to take our collective experience and apply it to add value to our clients, new and old. We act solely for you, not for insurance companies and the like, and we have gained over the years a sound reputation for quality financial advice. In a national magazine published in January 1998 we are selected as one of the best 10 independent advisers in the UK.

If this sounds attractive to you please get in touch.

- Review existing financial planning.
- Prepare goal setting strategies for investment protection.
- Reduce tax and increase investment returns.
- Invest for income and capital growth.
- Health, life assurance and private medical insurance.
- Planning for retirement.
- Simplify personal and corporate pensions decisions.
- Business protection

Services we provide

- packages, employee benefits, health and life assurance.
- Advice on off-shore investment opportunities for UK residents and expatriots.
- Use of trusts to save tax.
- Tax compliance services for self assessment and tax returns.
- School fees planning.