

# CHANGES TO THE SYLLABUS AND CORE READING FOR SUBJECT SA5 FOR THE 2009 EXAMINATIONS

## Changes to the Syllabus and their impact on Core Reading

*There have been no changes to the Syllabus.*

### Changes to Core Reading

#### UNIT 1

*This has been updated — see attached.*

#### UNIT 4

*This has been updated — see attached.*

#### UNIT 5

##### Sections 5.1.2 and 5.2

*These have been updated as follows:*

#### **5.1.2 The Markets in Financial Instruments Directive (MiFID)**

The MiFID was introduced in November 2007, it replaces the existing Investment Services Directive (ISD) while expanding the scope and coverage of the ISD regime. It provides a harmonised regulatory regime for investment services across the 30 member states of the European Economic Area. The main objectives of the Directive are to increase competition and consumer protection in investment services.

The MiFID:

- widens the range of core investment services and activities that are regulated by the EU to include personal investment advice; commodity derivatives; credit derivatives; contracts for difference and operating a multilateral trading facility.
- increases the governance and conduct of business requirements for firms in areas such as compliance, internal controls, outsourcing, record keeping, conflicts of interest and safeguarding of client money.
- sets out more clearly the allocation of responsibility between “home” state and “host” state for companies carrying out investment business in other countries.

Firms that comply with MiFID will, in general, have to comply with the new Capital Requirements Directive (CRD). For firms not previously covered by the ISD this could mean being required to hold minimum capital amounts for the first time.

The MiFID applies to:

- investment banks
- portfolio managers
- stockbrokers and broker dealers
- corporate finance firms

It also applies to many futures and options firms and some commodities firms. For retail banks and building societies the MiFID covers only parts of their business, for example selling investment products that contain securities to their customers.

## 5.2 Solvency 2

In the medium term the EU is carrying out a complete review of its model of insurance supervision as part of its Solvency 2 directive. The directive is still being consulted on, although the broad principles have been agreed, and proposed implementation is planned for 2012.

Solvency 2 will require companies to consider all of their risks in three pillar approach:

- Pillar 1 requires companies to hold sufficient capital to cover their insurance related risks and is very similar to the current approach to holding technical provisions, assets and minimum solvency requirements.
- Pillar 2 requires companies to hold sufficient capital to cover all their risks — even those which cannot be easily quantified — and will require companies to develop their internal controls and risk management practices and models.
- Under Pillar 3 companies will need to disclose their solvency positions and related information publicly.

Solvency 2 will establish two levels of capital requirements:

- The Minimum Capital Requirement (MCR) — the threshold at which companies will no longer be permitted to trade
- The Solvency Capital Requirement (SCR) — the target level of capital below which companies may need to discuss remedies with their regulators

The SCR may be calculated using a prescribed standard model or a company's internal model, where the latter will be benchmarked against the output of the standard model. It is likely that considerable work will be needed to justify using an internal model, and all but the largest companies are likely to find that any reduction in capital requirements is more than offset by the work needed to support the internal model. Thus it is likely that most companies will use the standard model.

Under the standard model, the capital requirement is determined through a combination of stress tests, scenarios and factor-based capital charges. The standard model allows for underwriting, market, credit default and operational risks. It aims to assess the company's net risk and determine its capital requirement after recognising all the risk mitigation arrangements the provider has in place.

Using the standard model has the advantage that the Solvency Capital Requirement calculation is less complex and a less time-consuming. However, using the standard model has the disadvantage that it aims to capture the risk profile of an average company, and approximations are made in modelling risks which mean that it is not necessarily appropriate to the actual companies that need to use it.

As an alternative to using the standard model for deriving Solvency 2 capital adequacy requirements a company can use an internal model of its risks. Internal models aim to create a stochastic model that reflects the company's own business structure. Companies can also use internal models

- to calculate its economic capital using different risk measures, such as Value at Risk (VaR) and Tail Value at Risk (TailVaR)
- to calculate levels of confidence in the level of economic capital calculated
- to apply different time horizons to the assessment of solvency and risk
- to include other risk classes not covered in the standard model.

*The only other changes that have been made to the Core Reading are to correct typographical errors and improve the style.*

**END**



## UNIT 1 — ECONOMIES AND MARKETS

### *Syllabus objectives*

- (a) Demonstrate a knowledge and understanding of the financial markets with particular reference to the needs of a United Kingdom user.
  - (i) Outline the main features of the capital markets in the United Kingdom, United States, Japan, Germany and France.
  - (iii) Outline the main features of the structures of the economies of the United Kingdom, United States, Japan, Germany and France.

### 1 The UK economy

The UK Government's economic strategy has six main elements:

- maintaining macroeconomic stability
- meeting the productivity challenge
- increasing employment opportunity for all
- building a fairer society
- delivering high-quality public services
- protecting the environment

The UK economy is the world's fourth largest (after the USA, Japan and Germany). Gross Domestic Product (GDP) was around £1.35 trillion in 2007.

The UK economy grew by about 2% in both 2002 and 2003. For 2004 it increased to 3% but for 2005 it fell to 1.8%. It increased to about 2.5% for 2006 and 2.6% for 2007 although it is expected to decline in 2008. The average annual growth of the economy since 1945 has been about 2.2%. In recent times the greatest growth has been in the service sector.

Consumer price inflation at 31 December 2006 was 3.1%, by 31 December 2007 it had fallen to 2.1%. The retail price index at 31 December 2006 was at an annual rate of 4.4%, at 31 December 2007 the rate was 4.0%. There were large downwards contributions to the movements in inflation from housing and household goods and a large upward contribution from food, with the largest increase arising from fresh vegetables.

In 2003 the base rate was reduced twice, then increased once and increased four times in 2004 to give a base rate of 4.75% at the end of 2004. During 2005 base rates were cut to 4.5% and then raised twice during 2006 to end at 5.0%. During 2007, rates were raised three times before being cut once to end the year at 5.5%. There have been a further two cut so far in 2008, with the rate currently at 5.0% (as at 15 May 2008).

The UK's current account deficit grew from £50.7 billion in 2006 to £57.8 billion in 2007. The rise in the annual deficit was mainly due to a higher deficit on trade in goods and a lower surplus on investment income

Around 75 per cent of people of working age in the UK are in employment. However, only one in five people of working age who are not working are classified as unemployed. A study by the Employment Policy Institute for the Joseph Rowntree Foundation found that there was a marked increase in non-activity among men aged 50+ during the last 20 years, whereas women are becoming more economically active as a group.

UK equities sharply underperformed bonds in 2000 and 2001, the cumulative performance for both years being the worst since 1974. Equity market performance for 2002 deteriorated further, resulting in the longest bear market for a generation. Likewise, US equities underperformed bonds in all three years. This was partly caused by the US, German and Japanese economies being either in or close to recession and was exacerbated by the terrorist attacks of 11 September 2001. Global tension remained high during 2002, economic growth was slow, corporate scandals reduced investor confidence and there was extensive selling by many institutional investors as the markets fell. Signs of recovery were seen during 2003, following rapid conclusion of the war in Iraq, with a return to positive global stockmarket returns. Returns continued to be favourable over 2004 and the UK equity rally strengthened into 2005, outperforming all other UK assets as well as the US equity market, which significantly underperformed every other major equity market. The UK equity rally continued in 2006. However, equity returns in 2007 were significantly eroded by the credit squeeze, giving very poor returns.

## 1.1 The banking sector

The Bank of England is the UK's central bank and is responsible for promoting and maintaining a stable and efficient monetary and financial framework. In pursuing this goal, it has three main purposes:

- maintaining the integrity and value of the currency
- maintaining the stability of the financial system
- seeking to ensure the effectiveness of the financial services sector

The Bank's monetary policy objective is to deliver price stability (defined by the Government's inflation target) and, subject to that, to support the Government's economic policy, including its growth and employment objectives. The bank's Monetary Policy Committee has responsibility for meeting this target and for setting interest rates.

Banks are supervised by the FSA. They are required to meet minimum standards on the integrity and competence of directors and management, the adequacy of capital and cash flow, and the systems and controls to deal with the risks which they experience.

## 1.2 The insurance sector

The insurance sector is supervised by the Financial Services Authority. Its prime focus is on insurers maintaining financial resources sufficient to meet their responsibilities to policyholders, including their ability to absorb any market falls that may occur.

The London Insurance Market (London market) is a distinct part of the UK insurance and reinsurance industry. It is the main centre for world reinsurance business and for energy, marine, aviation, satellite and other forms of transport insurance. It comprises insurers, reinsurers, Lloyd's syndicates, Protection and Indemnity Clubs (mutual insurers for shipowners) and brokers.

## 1.3 Investment

The UK has considerable expertise in fund management, which involves managing funds on behalf of investors, or advising them how best to invest their money. The main institutional groups are long term insurance funds, general insurance funds, self-administered pension funds, investment trusts and unit trusts.

## 2 Major overseas markets

### 2.1 United States of America

The USA is the world's largest economy. It is an advanced, mature economy with a strong market orientation and covers the whole range of activities. It has a huge domestic market and many natural resources. It is almost self-sufficient in raw materials.

The size of the economy and the domestic market means that economies of scale can be more easily achieved than in other countries but the scope for growth is lower than in newly industrialised nations due to its maturity. There have been pockets of high growth, particularly in high technology industries but these have suffered since the boom of the late 1990's. The main economic worries centre on the impact of the emerging "two-tier labour market" where those without education and the skills required by modern high-tech industries and professions are excluded from economic prosperity. More recently, the impact of the credit squeeze is severe.

There is a wide choice of industries and companies in which to invest. The stock market is very large and marketability is high. The country is politically stable, accounting standards and information flows are good and there are no language problems.

In common with performance throughout the world during 2002, US share prices fell for the third consecutive year, making this the longest bear market for a generation.

The contributory factors included:

- loss of investor confidence following a series of corporate scandals and defaults, including Enron and WorldCom

- increasing tension in the Middle East culminating in the war against Iraq in March 2003

Interest rates were further cut to 1.25%, and to 1% in June 2003.

During 2003, the US equity market led the global rally in equity stocks. This followed the end of the war in Iraq and was mainly due to productivity gains, dollar weakness and improved sentiment.

The US equity market performed well in 2004. Interest rates rose four times to 2.25% to maintain stable, low inflation. Oil prices rose over the year but a fall towards the end of the year and the completion of the election process brought a year end rally in share prices. US companies have been generating high levels of cash flow, have reduced debt and are returning cash to shareholders providing a positive outlook.

The US equity market has performed reasonably well in 2005 although somewhat behind the recoveries in other developed countries. Interest rates were increased on eight occasions during 2005 - increasing the rate from 2.25% to 4.25%. The rate increases were a largely a response to concerns about inflation in the US economy driven by a burgeoning trade deficit and contract-high oil prices. Oil prices globally increased in response to a combination of supply-side problems in the middle east and the gulf of Mexico combined with sustained high demand from emerging market economies such as China and India.

Over 2006, US equity performance rebounded strongly. Figures from Barclays Capital report a real return of 13.3% compared to 11.4% for UK equities and -1.2% for US bonds. In May 2006, share prices fell globally (by 9% in the US) due to concerns over the impact of a hike in oil prices. Share prices rose again once the oil prices fell and concerns abated. Interest rates in the US continued to rise until the middle of 2006. After 17 consecutive rises, the US Federal reserves have kept rates on hold at 5.25% since August 2006.

Over 2007, US economic growth has been volatile, mainly reflecting the impact of energy prices on consumer spending. Figures from Barclays Capital report a real return of 3.2% compared to 1.0% for UK equities and 5.2% for US bonds. The underlying indicators have been deteriorating with continued sub-prime mortgage defaults leading to a widespread tightening of lending requirements, increasing the risk of a recession in 2008.

The US Federal Reserve cut interest rates three times during 2007 to reach 4.25% by the end of the year. This has been followed by a further four cuts so far in 2008 to 2.0% (at 15 May 2008). The Federal Reserve has stated that it has cut rates reluctantly because of ongoing inflationary concerns, including the effect of a weakened dollar pushing up the price of imports.

There is a wide choice of industries and companies in which to invest. The stock market is very large and marketability is high. The country is politically stable, accounting standards and information flows are good and there are no language problems.

The American stock market is the largest in the world. The largest stock exchange in the USA is the New York Stock Exchange (NYSE), which covers all the major stocks. The

American Stock Exchange is also situated in New York, and covers companies not large enough to qualify for the NYSE.

There is also a nationwide electronic trading system covering all the regional exchanges, known as the National Association of Securities Dealers Automated Quotations (NASDAQ). NASDAQ is the second largest equity market in the USA. During the late 1990s the NASDAQ saw a huge growth in the number of US retail investors actively trading shares, often using online trading platforms.

The US bond market is the world's largest. Fixed interest stocks are issued by both government and corporations. Dollar denominated fixed interest stocks (including Eurodollar bonds) represent around 50% of total world market capitalisation. Marketability is good, particularly for new issues. The average term of US bonds is shorter than for UK bonds although 30 year bonds are available.

The US government started to issue index-linked bonds in 1997. By the end of December 2005, the total market value had reached US\$ 340 billion, over 40% of the world market compared with the UK issue of US\$ 200 billion

The American market is very strictly regulated by the Securities and Exchange Commission (SEC). The US system is based almost entirely on statute, with a minimum of self regulation.

## 2.2 Japan

Japan is the second largest economy in the world. It is technologically advanced and very successful internationally, based on efficient manufacturing processes and protectionist policies which have safeguarded the domestic market. There has also been a strong commitment to success on the part of the workforce and management.

The country has few indigenous energy sources and raw materials. However, it is advanced in manufacturing and over the years has become strongly export-based with an emphasis on manufactured goods such as cars and consumer electronics. However, the strength of the yen, reflecting large trade surpluses, has put a squeeze on exporting industries, so that Japanese companies often find it cheaper to manufacture overseas. There is a strong services sector. In 2007 the current account surplus amounted to some US \$210 billion.

During the 1990s, the economy grew by an average of only 1% per annum despite substantial fiscal and monetary stimuli (a fiscal deficit of nearly 10% of GDP and near-zero interest rates).

In 2003, the Japanese stock market benefited from the global upturn in economic activity. However, many of the imbalances and structural issues still remain. Unemployment was around 5% of the working age population, which is above the historical average in Japan, and deflation was an established feature of the economy.

In 2004, high oil prices held back the equity market but led to inflation for the first time since 1998, which is seen as positive for the economy. There had been increased

confidence within Japanese companies which has supported the labour market. However, there are concerns about the strength of the Yen reducing the export trade. Government debt amounted to around 150% of GDP, the highest ratio among the major world economies.

Performance continued to improve in 2005, with higher consumption and an increased confidence in an economic recovery. Unemployment is lower but and now under 5% of the working population. However, returns were muted in 2006 and fell dramatically in 2007.

Savings levels are high, and traditionally provided the capital for high levels of real investment. However, in recent times much of the surplus funds have been attracted into overseas (largely US) “safe-haven” investment.

Investment opportunities exist in a wide range of industries and companies. Accounting standards are less objective than those in other countries and, although many companies publish their reports and accounts in English, information may be less readily available than in other countries. Private capital investment remains high and corporate profitability is strong. Companies are cutting costs, investing in new technology and cross shareholdings are being unwound.

The Japanese stock market is the second largest in the world. There are five stock exchanges, the largest being the Tokyo Stock Exchange, which accounts for over 80% of total turnover. There are no restrictions on foreign investment, except for investment in certain companies regarded as being of national interest, where investment is restricted to 25% of the equity.

The Japanese bond market is the second largest in the world. There is a mixture of government and corporate bonds. The average term of Japanese debt securities has been increasing over the last decade. However, long bonds are still uncommon.

## 2.3 Germany

Germany is a mature industrialised country with a high proportion of exports as a percentage of GDP. Germany also has a large banking and insurance sector. The maturity of the economy has led to modest growth rates averaging 1.5% per annum in the 1990's but, on the other hand, the country has benefited from low inflation and the currency has been strong. However, since joining the European Single Currency in 1999, the exchange rate has declined significantly. There are currently concerns about production costs in Germany, particularly labour costs, and unemployment is a significant problem at around 8% of the working age population, although this is lower than in recent years.

During 2003, Germany experienced its second recession in three years and started to move out of recession at the end of the year. It was the world's biggest exporter in 2004, but the continued high level of unemployment is undermining the economic outlook. In 2005, political uncertainty and inflation above the 2% target were key features. However, equities benefited from companies restructuring and controlling wage costs.

The need to develop the infrastructure of East Germany, and the development of market economies in Eastern European countries, are providing substantial opportunities as well as problems.

The German banks have major investments in domestic industrial companies, which themselves often have interlocking shareholdings in each other. Finance for industry often comes directly from the banks. This means that despite the size of the economy, which is much larger than that of the UK, investment opportunities are somewhat more limited than those in other countries. The liquidity of the stock market is less than that of the UK.

There are several regional stock exchanges in Germany, of which Frankfurt is the largest. Together they form the fifth largest market after New York, Tokyo, London and Euronext.

The bond market has been increasing in size recently, from a relatively low base. The average term of bonds is quite short and very long dated bonds are quite rare. Yields have tended to be quite low (by past UK standards), reflecting the market's confidence in the ability of the Bundesbank to keep inflation low. A similar policy is now being followed by the European Central Bank in respect of the single currency (of which Germany is a participant).

There are no restrictions on foreign investment.

## 2.4 France

France has a broadly based economy and the Government works closely with industry on major projects. Manufacturing is important and services also represent a significant proportion of GNP. Agriculture still exerts great political influence. GDP per head has been similar to that of Germany in recent years. A privatisation programme is in progress.

The need to control government spending on the welfare system and on industrial and agricultural subsidies is proving a major political problem for the government, as is the level of unemployment.

The traditionally high degree of regulation of the securities market is now being eased. Accounting policies are more conservative than those in the UK. Corporate information is not as freely available as in the UK. Marketability of stocks is relatively limited.

In 2000, the French stock market merged with the Brussels and Amsterdam markets to form Euronext, the leading European exchange. The Portuguese exchange was added in 2001.

The French bond market is rather smaller than that of Germany, and similar in size to that of the UK.

There are few restrictions on foreign investment by EU members.

## 2.5 European Monetary Union

European Monetary Union, which became effective in January 1999, is having a profound effect on the economies of the participating countries and will also affect those European countries which stay outside. For the countries inside EMU there is a single monetary policy set by the European Central Bank to achieve price stability across the Euro region as a whole. Fiscal policy will continue to be set by the individual national governments but within the framework of the Stability and Growth Pact (the “Maastricht Treaty”) so that fiscal policies are likely to converge.

There is a freer single market in goods and services with more transparency of prices and costs. A single currency removes the exchange rate risks of investing in other EMU participants and there has been a rebalancing of institutional portfolios to reflect the increased attractiveness of investments in other EMU countries. There is also fierce competition between European investment exchanges, resulting in some radical restructuring as noted above.

The UK Government continues to state that it believes the UK should join EMU provided there is a strong economic case for doing so. The Chancellor of the Exchequer has specified five economic tests that have to be passed before the UK will join. It is felt that economic convergence is unlikely to be achieved for several years.

**END**

## UNIT 4 — TAXATION

### *Syllabus objective*

- (c) Demonstrate a knowledge of the personal and corporate taxation framework in the United Kingdom.

## 1 Income tax

### 1.1 Schedular system of income tax

In the UK, all income is classified into four schedules, depending on the source of the income:

Schedule A	Income from land and property, primarily rental income from leases
Schedule D	Case I (profits from trades) and II (profits of professions or vocations) relating to self-employed income
Schedule E	Case I — income from employment, which is taxed under “Pay as You Earn” (PAYE) arrangements
Schedule F	Dividends paid by companies

Income under all schedules is totalled when assessing an individual’s overall liability.

### 1.2 Income tax allowances

	2008 / 09	
	<i>Personal</i>	<i>Additional married *</i>
Basic allowances	£6,035	£2,540
Age 65–74	£9,030	£6,535
Age 75 and over	£9,180	£6,625
Income limit for age allowance		£21,800
Blind person’s allowance		£1,800

\* Tax relief is limited to 10% and is only available to taxpayers born before 6 April 1935.

Personal allowances are deducted from income before calculating income tax. The extra age allowances are reduced by £1 for every £2 where total income is more than the age allowance threshold.

Additional tax credits are given to low income families, disabled persons and pensioners.

### 1.3 Married couples

Husbands and wives are independently subject to income tax with their own allowances and rates. Where spouses hold assets jointly, the income arising is normally allocated equally between them.

### 1.4 Income tax rates

In 2008 / 09 the rates of income tax are as follows:

<i>Taxable income</i>	<i>Rate</i>
First £34,800	20% (the basic rate)
Over £34,800	40% (the higher rate)

Interest is taxed at 10%, 20% and 40%. The tax rates applicable to dividends are 10% for income below the higher rate threshold and 32.5% above that. The first £70 of interest from an ordinary account with the National Savings Bank is exempt from tax.

### 1.5 Benefits in kind

Benefits in kind (“fringe” benefits) provided to employees are treated as if they were earnings for tax purposes, even though the employee is not actually paid any money. The tax is based on the “cash equivalent” — normally the cost of providing the benefit. The major benefits are:

- *Beneficial loans* — the taxable benefit is the interest saved compared with the Inland Revenue official rate. Loans up to £5,000 are exempt.
- *Use of assets* gives rise to a taxable benefit of 20% a year of the market value when the asset was first made available to the employee. (There is a limited exemption for computer equipment.)
- *Living accommodation* is taxed on gross rateable value or rent paid by the employer, if greater. If the property costs more than £75,000, there is an additional benefit based on the official interest rate.
- *A company car* has a cash equivalent based on its list price when new and the level of carbon dioxide emissions. Fuel for private use is taxable according to a fixed scale.
- *Medical insurance*

## 2 Inheritance Tax

Inheritance Tax (IHT) is a tax on the value of a deceased person's estate at death plus certain lifetime transfers which are not exempt (or potentially exempt). Husbands and wives are taxed separately; however, there is no IHT on transfers between spouses. Other exemptions include:

- an annual exemption for lifetime gifts of up to £3,000 per donor
- small gifts of up to £250 per donee
- normal expenditure that is regular, made out of income and does not reduce the donor's normal standard of living
- gifts in consideration of marriage (up to certain limits)
- gifts to charities or major political parties

IHT is charged at 40% on death and at 20% on certain lifetime transfers. The first £312,000 is charged at a nil rate.

Where a donor of a lifetime gift dies within seven years of making the gift, IHT may be due on the gift. The full rate of tax is reduced depending on the interval between the gift and the date of death. Such transfers, where there is no immediate liability to IHT, are known as "potentially exempt transfers".

The value of assets for IHT is their open market value. An asset that a person has given away may still be treated as forming part of the donor's estate on death if he or she has retained a benefit in the asset (a "gift with reservation").

Relief is given on business assets provided the transferor has owned them for at least two years.

## 3 Corporation Tax

Companies that are resident in the UK are subject to Corporation Tax (CT) on their profits (income plus gains). Non-resident companies may be subject to CT where they trade in the UK through a permanent establishment.

Companies qualify for some special tax reliefs, including:

- relief on qualifying revenue expenditure on research and development
- relief on corporate venturing — subscribing for shares in a qualifying unquoted company
- relief on depreciation of intangible assets acquired on or after 1 April 2002.

The main rate of CT is 28%. This is charged on the whole of profits where they exceed £1.5m (and in all cases for closed investment-holding companies). A small companies' rate of 21% is charged on the first £300,000 of profits where profits are below £1.5m. There is marginal relief for profits between £300,000 and £1.5m.

Where a company has associated companies, all the rate thresholds are divided by the number of associated companies plus one.

A company's trading losses can normally be set against:

- income and gains of the same accounting period
- income and gains of a previous year
- trading profits from the same trade in future years

## 4 Capital Gains Tax

Capital Gains Tax (CGT) is charged on net gains i.e. total chargeable gains realised during a tax year after deducting total allowable losses realised in the year.

CGT can only arise on the disposal of an asset. Normally this means sale but it could also mean a gift or compensation for loss or damage to an asset. The value on which the gain (or loss) is based is normally the consideration received.

No CGT is payable on death and beneficiaries of a deceased person's estate are treated as if they had acquired the assets of the deceased at their market value on death.

Certain costs are allowable in computing chargeable gains:

- the acquisition cost (or market value on 31 March 1982 if the asset was acquired before that date)
- costs of acquiring and disposing of the asset
- expenditure on enhancing the asset's value
- indexation allowance (see 4.1 below)

Losses brought forward from previous tax years can offset gains.

For 2008/09, the first £9,600 of an individual's net gains realised during the tax year are free of CGT. The excess is taxed as if it were the "top slice" of income, at the rates that apply to savings income. Husbands and wives are subject to CGT separately, each with their own annual exemption and tax rate. Transfers between spouses are not liable to CGT. For gains above the annual exempt amount the CGT rate for 2008/09 is 18%. A new entrepreneurs' relief will reduce the effective tax rate on some gains to 10%.

## 4.1 Indexation allowance

The indexation allowance can reduce the chargeable gain (for assets acquired before 1 April 1998) but it cannot increase a loss or turn a gain into a loss. The acquisition cost and enhancement expenditure (before April 1998) are revalued in line with indexation factors derived from the RPI between the dates of expenditure and the earlier of the date of disposal and 1 April 1998.

The indexation allowance is calculated by multiplying the allowable expenditure by the indexation factor.

## 4.2 Taper relief

Taper relief reduces the chargeable gain by reference to how long the asset has been held. It is applied to net gains after any indexation allowance. Losses are deducted so as to minimise the total chargeable gain. Different rates of taper relief apply to business assets and non-business assets.

## 4.3 Main exemptions

Gains on certain assets are exempt (and losses not allowable), including:

- an individual's (or married couple's) only or main residence
- government securities, loan stocks, qualifying corporate bonds and National Savings and Investments certificates
- ISA and PEP investments
- life assurance policies disposed of by their original owner
- betting and lottery wins
- shares held by the trustees of share incentive plans
- enterprise investment scheme, venture capital trust and business expansion scheme shares
- chattels (provided the consideration is not more than £6,000)

## 4.4 Companies

Companies are subject to Corporation Tax on chargeable gains at the normal rates. Companies continue to receive indexation relief on gains (and do not receive taper relief). Capital gains may be offset by capital losses of the same accounting period or capital losses brought forward from previous periods. Qualifying disposals of substantial holdings (at least 10%) are exempt.

## 5 Taxation of investments

### 5.1 Money market instruments

All of the return from money market instruments is taxed as income. This is true even where a security is issued at a discount to its redemption value. For basic rate tax payers tax on money market instruments and deposits is due at the rate of 20%. (A lower rate of 10% applies to savings income but only when the individual's non-savings income is very small.).

Taxed savings income is received after 20% tax has been deducted at source. Basic rate taxpayers therefore have no further tax to pay and higher-rate taxpayers are liable for a further 20%. Where taxed savings fall into the 10% rate band, or is covered by allowances, then the taxpayer can reclaim the tax deducted to the extent that it exceeds the tax actually due.

### 5.2 Gilts and other qualifying securities

All investors can now receive interest before deduction of tax, although they can elect to receive it net if they wish.

Institutional investors pay a uniform tax on interest and capital gains. Relief is available on capital losses.

Trusts and individual investors are liable to pay income tax on interest received and accrued but capital gains are tax-free.

Most (but not all) Eurobonds are "qualifying bonds" and do not attract capital gains tax. "Deep discounted" bonds incur income tax (not capital gains tax) on gains.

#### 5.2.1 Gilt strips

The whole of the capital gain will be taxed as income on an annual basis even in the hands of individual investors.

## **5.3 Equities**

### **5.3.1 Franked income**

Franked investment income (i.e. net dividends plus a 10% tax credit) is added to the investor's taxable income. The tax credit can then be used to reduce the investor's resulting liability to tax.

The tax credit is taken as covering the tax liability of lower and basic rate taxpayers and the higher rate of tax on dividend income is reduced to 32.5%.

Charities received compensation from the Treasury for the loss of the tax credit from April 1999 in the form of a payment of a proportion of the amount of dividends received, declining to zero over five years.

### **5.3.2 Tax on capital gains**

The taxation of capital gains was changed from 6 April 2008 when taper relief and indexation allowances were abolished. Unless there is eligibility for Entrepreneurs' Relief (which, for shares, requires at least 5% of the ordinary share capital to be held), individuals will pay 18% tax on capital gains above the annual exempt amount (£9,600 for 2008/9).

Companies will continue to be charged to corporation tax on chargeable gains.

## **5.4 Convertibles**

### **5.4.1 Income**

Income from convertible loan capital is taxed in the same way as from normal loan capital.

Income from convertible preference shares is taxed in the same way as from normal share capital.

### **5.4.2 Capital gains**

Convertibles are non-qualifying securities so there is no capital gains tax exemption.

## **5.5 Unit trusts**

Here we are concerned with the way in which an investor who holds units in a unit trust is taxed.

### **5.5.1 Tax on income**

For a basic rate taxpayer there is no further tax to pay. A higher rate taxpayer has additional tax to pay. This additional tax is payable whether the unit trust pays out its income or accumulates the income within the trust.

### 5.5.2 Tax on capital gains

Capital gains tax is applied to unit trust holdings in the normal way.

### 5.6 Investment trusts

Shares in investment trusts are treated like normal equity investments. So the distributed income counts as franked investment income and selling shares in an investment trust may give rise to a capital gains tax liability in the normal way.

### 5.7 Property

Normal rules apply. Rental income is subject to income or corporation tax and is not treated as “savings” income for individuals. Capital gains tax is payable on gains.

### 5.8 Derivatives

For authorised unit trusts all proceeds from options and futures are free of tax. For most other institutions, proceeds from derivatives are taxed as capital gains.

### 5.9 Stamp duty

Stamp duty is paid at the time of transfer of title by the purchaser of shares and property. The amount payable is expressed as a percentage of the market value of the asset.

The rates of stamp duty on property are higher than on shares and other securities, as the following table demonstrates:

<i>Value of asset</i>	<i>Property</i>	<i>Shares and other securities</i>
Up to £125,000*	Nil	0.5%
£125,001–£250,000	1%	0.5%
£250,001–£500,000	3%	0.5%
Over £500,000	4%	0.5%

\* £150,000 for residential property in disadvantaged areas (relief for non-residential transactions was withdrawn on 16 March 2005)

### 5.10 Taxes on overseas investment

The overseas investment income of UK residents is subject to UK tax. However, the existence of double taxation agreements between the UK and many other countries means that tax paid in those overseas countries can be offset against UK tax.

Profits tax or corporation tax paid in overseas countries on corporate earnings can usually be offset against any UK corporation tax on that slice of earnings. If the rate of corporate

tax in the overseas country is higher than or equal to the rate of corporation tax in the UK, then no UK corporation tax is payable on that slice of earnings.

Most countries impose a withholding tax on dividends and sometimes interest payments made overseas. These withholding taxes can be set against UK tax liabilities.

In the UK, withholding tax on international bond interest was abolished from April 2001.

From April 2008, provided certain conditions are met, dividends from non-UK companies will be given the same notional tax credit as for dividends from UK companies i.e. no additional tax liability for a basic rate tax payer and an additional 25% tax on the net dividend for a higher rate tax payer.

## **6 Financial institutions**

### **6.1 Pension funds and charities**

UK approved pension funds and recognised charities are exempt from income tax and capital gains tax on their investments. They can reclaim, from the Inland Revenue, any income taxes deducted at source on interest but not the tax credit attaching to dividend payments. In the case of overseas investment income, withholding tax deducted in the host country cannot be recovered.

### **6.2 Life assurance funds**

Under the Crown Option the life assurance business of UK life offices is usually taxed on an "I-E" basis. This permits policyholders' unfranked investment income, including chargeable gains to be taxed at the lower rate of income tax, 20%, for financial years 2003 onwards. Also, UK dividend income is not subject to further tax while the amount of taxable income can be reduced by certain business expenses.

Investment income and capital gains on policyholders funds in respect of pension and overseas business undertaken by a life assurance company can be considered as effectively free of tax except that the tax credit on franked investment income can no longer be reclaimed.

For a proprietary office the taxation of the shareholders' share of taxable income is intended to bring the total tax liability in line with that payable by a normal trading company.

### **6.3 General insurance companies**

All UK incorporated insurance companies are, prima facie, deemed to be tax resident in this country as are companies incorporated overseas but managed and controlled in the UK. A UK tax resident company is subject to UK corporation tax on its worldwide profits. An overseas company carrying on insurance business in the UK through a branch or agency is subject to UK corporation tax on the profits of the UK branch or agency.

The profits of a proprietary general insurance company calculated for taxation purposes are likely to differ from those disclosed in its financial statements. These differences may relate to:

- the investment return, notably on equities
- the underwriting result
- other items, such as depreciation and disallowable entertaining
- overseas profits

The principal distinguishing features of the taxation of mutual insurers are:

- Underwriting losses and profits are regarded as arising from mutual trading and hence are exempt from tax.
- The investment return is taxed independently.
- No relief is given for expenses, which are assumed to be part of the mutual trade.

For tax purposes the insurance technical provisions are deductible following the accounting policy adopted in the financial statements.

Health and care insurance business is generally treated as a subsidiary fund within long term or short term insurance companies.

Provident health insurers are taxed either as mutuals or proprietary companies depending on the corporate structure of the insurer within any holding group.

Since January 2001, general insurance companies (and most Lloyd's members) have faced a clawback of the tax benefits they get by not discounting their provisions for unpaid claims. This restriction will also apply where they significantly overestimate the provisions for settling claims in future years.

## **6.4 Investment trusts**

Investment trusts pay corporation tax at a rate of 28% on unfranked investment income. (The Corporation tax rate for larger companies was reduce from 30% to 28% from 6 April 2008.) Management and interest charges can be offset against such income. Net franked investment income is not subject to further corporation tax. Approved investment trusts are exempt from capital gains tax.

## **6.5 Unit trusts**

### **6.5.1 Authorised unit trusts**

Authorised unit trusts pay corporation tax at the special rate of 20% on unfranked investment income less management expenses. Franked investment income is not subject to further corporation tax. Unit trusts are exempt from capital gains tax.

**6.5.2 Exempt trusts**

These trusts do not pay tax on either income or capital gains.

**6.6 OEICS**

The taxation of OEICs will be broadly the same as for unit trusts.

**6.7 “Traders in securities”**

Institutions such as banks, proprietary general insurance companies, building societies and discount houses are classified as “traders in securities”. Their profits, whether from income or realised capital gains, less expenses, are taxed at the corporation tax rate.

<b>END</b>
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