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PARTNERSHIP PENSION ARRANGEMENTS

by

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1. INTRODUCTION

This paper outlines some of the more recent developments in the field of planning partnership pensions. In particular, I have covered the self-invested funds which are now available through insurance companies or "private" friendly societies - a friendly society established just for the members of a particular partnership.

The word "partner" means different things to different people. For the purpose of this paper, it refers to one of a group of people who are working together in an unincorporated body. They are taxed as "self-employed". The legislation governing their pensions is quite different from that which applies to employees taxed under Schedule E.

I have not gone into the details of how a retirement annuity policy works because this will be familiar to most of my readers. (Details are available in some of the references.) Also, I have not gone into the details of how to choose a suitable policy - although some points for consideration are included. Speculating on whether insurance companies' bonus rates are set to fall comes within this category and so I have not included anything on this point either. If this makes the paper appear unbalanced, then I apologise, but the alternative is to reiterate much which is already well known.

My thanks are due to Ewan Calder, Steven Haberman, Michael Weitzman, and Andrew Adams for their helpful discussion and comments at various times. However, the mistakes are as usual all my own responsibility.

Many thanks to Richard Wilkinson for persuading Reliance Mutual's printing department to print this paper.

2. PLANNING OBJECTIVES AND METHODS

The shoes of the cobbler's children are always in the worst condition. Similarly, it is difficult for the members of a busy partnership, concerned as they are with advising their clients, to find time to consider their own affairs.

They may consider that, in principle, pensions are an important matter for them. Nevertheless, in practice, there are often apparently more pressing items for discussion at partners' meetings. Also, the forum of a partners' meeting, where partners' different views have to be heard and assimilated, makes it difficult in some cases for firm decisions to be made. Although there may be acknowledged advantages in acting together in planning their pensions, it may be difficult for the partners to reach the necessary agreement. So, even the best plans may not see the light of day in the end.

It certainly helps at the time of planning pensions if the adviser can solve some of the apparently more pressing problems at the same time as making the pension arrangements. For a typical partnership these problems (not necessarily in the correct order) may be:

(1) Getting clients' work done,
(2) Raising capital,
(3) Reducing the immediate tax bill, and
(4) Securing the partnership succession.

However well designed a pension plan is, it is most unlikely to be able to help with getting the practice's work done. But it may well be possible to tackle the next two items on the list. Indirectly, it may also be possible to help with the partnership succession.

Types of Partnership

Different partnerships will have different capital requirements. Even within the same firm there may be a range of ages and, hence, a variety of outlooks on the subject of pensions.

At the one extreme there will be the senior partner. He may have a substantial stake in the firm's capital and will, no doubt, be most concerned about maximising his retirement income.

At the other extreme, the more junior partners may be very much less concerned with retirement income than with how they are going to replace the senior partner's capital when he retires. They may be so concerned about this possible drain on their resources, together with school fees and the like, that they may feel they have no money available to set aside for their future retirement. For them, the possibility of using their retirement annuity fund to reduce pressure for capital for the practice may be a prime consideration.

The Ideal Pension Plan

The ideal pension plan is easy to define:

The main point of the pension scheme must be to provide for the partners in their old age, but this should be done in the most tax-effective, most flexible and least costly way, whilst achieving the highest possible investment return for the minimum risk.

But this is not so easy to put into practice.

The solutions available to partnerships are a super-set of the solutions for individuals. That is to say that the solutions which apply to an individual will apply to a partnership as well. But there are additional resources at their disposal. The mainstay is, of course, to set up schemes under section 226 of the Taxes Act.

The S226 policies can be effected either through the usual insurance route or through a self-administered scheme. Other possibilities which will be considered from time to time will include partnership annuities under section 16 of the Finance Act 1974, simple consultancy agreements or even a partner's resignation and re-employment by the partnership so that he may benefit under a scheme approved under the Finance Act 1970.

The Role of The Adviser

There seems to be a special role for Actuaries here in the analysis of the available retirement annuity policies. The premiums, if they are to support even one partner at a reasonable standard, will have to be large and for a partnership the premiums can be quite substantial. It may, therefore, pay the partners to hire the necessary specialist advice even if they would not ordinarily do so in connection with their life assurance policies.

It will also be useful for the adviser to ensure that realistic assessments are made of the likely proceeds from a partner's existing policies. Even though the policies may be from different insurance companies, these projections can be made on a consistent set of assumptions. The projected benefits can be compared with the partner's anticipated remuneration near retirement allowing for a range of possible earnings increase rates. To be consistent, the projections should allow for anticipated increases in contributions as earnings rise.

The advantage from the partner's point of view is that he can then see whether his present policies and rate of contribution are likely to provide a reasonable level of benefits when he retires. He may have difficulty in relating the usual insurance company projections, which are in money terms, to their real eventual purchasing power. By expressing the figures as a percentage of the partner's final earnings, this problem is effectively overcome.

Partners may well find that they have to contribute at, or close to, the maximum permitted levels if they are to anticipate a reasonable retirement income. The maximum period for which unused relief can be carried forward is six years. So, if contributions are missed early in life, the legislation does not allow these to be made good later on.

Life Assurance Cover

Life cover can be arranged under the terms of S226A. However, the premiums come out of the maximum contributions allowed under S226. Therefore, where a partner wishes to save at the maximum rate, he may be better off paying for his life cover through ordinary term assurance so as to maximise his retirement annuity premiums.

Loanbacks

Where a partner wishes to take a loan in connection with his retirement annuity policy, consideration will have to be given as to how this can be repaid.

If the loan is for house purchase or the like, the most likely source of capital to repay it is the tax-free lump sum on retirement. Care should therefore be exercised to ensure that this is likely to be sufficient. Where the loan is to be used to fund partnership capital, the capital itself should be available upon the member's retirement to repay the loan. Indeed, repayment may be more of a problem for the remaining partners who will have to plan how they will finance it than for the partner taking out the loan.

Commission

Many partnerships will have agency agreements with various insurance companies entitling them to commission on business they put with those companies, including their own retirement annuity business.. Alternatively, they may be able to arrange for a rebate of part of the commission from their intermediary.

This raises the question as to whether they would be better off by receiving the commission or by arranging for it to be used to augment their retirement annuity policies. Given that the commission would be a taxable receipt in their hands, the simple answer is that it should be used to augment their policies. Otherwise, they may simply have used up part of their valuable and limited tax relief on contributions to no end.

There might be exceptions to this rule. For example, there might be a delay between receipt of the tax relief on the contribution and paying tax on the commission. This is because the premium relief may be received almost immediately whereas the commission may be taxed on a preceding year basis. A partnership in great need of cash might consider this important. Where the partnership has a separate financial services company which would receive the commission, finding the optimum solution is even more difficult.

Nevertheless, using the commission to augment benefits within the policy is a sound rule in most circumstances.

3. INSURED PENSION SCHEMES

Retirement annuity contracts approved under S226 of the Taxes Act have a number of important tax reliefs. These are summarised very briefly below:

1. Contributions are allowable for income tax purposes.

2. The investments underlying the scheme are not subject to tax.

3. Part of the policy proceeds at retirement (roughly 25% to 30% in practice) can be taken as a tax-free lump sum. The rest must be taken in the form of a pension which is taxable.

4. If the policyholder dies before retirement, his accumulated fund can be paid free of capital transfer tax to his dependants.

Since the main features of these contracts are, I am sure, familiar to most of my readers, I shall concentrate on three aspects which may be of particular interest to actuaries:

1. The analysis of the charges inherent in these policies.

2. Some comments on investment.

3. Loanbacks.

3.1 ANALYSIS OF CHARGES

It is a general feature of commerce that it is largely to do with producing goods and services for one price, and then selling them on for another. The life assurance industry is no exception to this and the usual expense loading for the industry is around 25%. (This is used to meet the companies' costs and overheads, as well as servicing their capital.) This 25% figure does not seem excessive by comparison with the "mark-ups" of many other industries. Nevertheless, given the large amounts which can be invested in retirement annuity policies, if this expense loading or a large part of it can be avoided, the saving may be well worthwhile.

The insurance companies' expense loading comes in the form of charges deducted from premiums and the funds under management. Are these charges significant in the light of the differences in investment performance of different policies? The answer appears to be yes, very significant. To see this, one may consider policies maturing recently after 20 years. The median policy produced a pension of £5,178 pa from contributions of £500 pa. Adding back in the effect of the estimated charges produces a notional pension figure of £6,400 pa. Only one of the 21 companies in the survey beat this figure.

In other words, choosing only average investment performance but reducing the charges made from the premiums seems to have scope for dramatically improving the overall return. Of course, the above figures were all for with profits policies and there is no such thing as a policy with no charges. Nevertheless, this looks like a promising avenue for the potential policyholder to examine. [Source of pension figures: Self-Employed Pensions by Janet Walford.]

How to Reduce Charges

There are 2 ways to try to reduce the charges suffered by the policy holder:

First of all, through the choice of a suitable policy. It is well known, I hope, that the charges under regular premium policies are markedly higher than under an equivalent series of single premium policies from the same insurance company and invested in the same funds. This is despite the obvious savings in administrative costs which the insurance company can achieve through writing regular premium business. The reason is, of course, that the marketing costs are higher.

The advantage to the policy holder of having a single premium policy as opposed to a regular premium one, might typically be of the order of 8% of the pension at retirement. This is roughly the difference between an average policy and an upper quartile one. This improvement in performance is easy to achieve simply by selecting the right policy.

Secondly, and particularly in the case of partnerships which may have a considerable amount to invest, there is the possibility of obtaining special terms from the insurers. A large partnership which approaches the insurers direct might seek an improvement in terms equivalent to the normal commission rates. Alternatively, they might seek to negotiate similar terms with their chosen intermediary. In addition, they may look for what in another industry might be termed a "quantity discount", depending on the size of their premiums.

Principles of Analysis

Although the principles by which the charges under unit linked policies can be analysed are well known to Actuaries, it is worth including an example to see how the charges break down in a typical case. The charging structures inherent in with profits policies are not published, but there is no reason to believe that the net results would be very different.

I have chosen as my example a fictional policy (but not too far removed from real life) with the following charges: There is an initial charge of 5% included within the unit price. There are recurring management charges of 0.75% per annum deducted monthly, and the first 2 years' premiums are invested in "Capital Units" which suffer an additional 3% per annum charge.

It is then possible to calculate the proportion of each premium taken by the insurance company's charges. This may be done by projecting forward the unit prices allowing for the charges and calculating the accumulated policy proceeds. This may be compared with the notional policy proceeds if the charges were zero. A computer spread-sheet calculator is a convenient aid for the calculations.

The results of this analysis are set out in the following table for a policy with a 20 year term.

PROPORTION OF PREMIUM TAKEN BY:

	Initial charge	Ordinary annual charges	Additional charges on capital units	Total
1st premium:	5%	13%	38%	56%
2nd premium:	5%	13%	36%	54%
3rd premium:	5%	12%	-	17%
5th premium:	5%	11%	-	16%
10th premium:	5%	8%	-	13%
15th premium:	5%	4%	-	9%

For each premium these figures represent the capitalised value of all the future charges which will be made by the insurance company against that premium.

It will be seen that the charges are particularly heavy during the first two years and that, in fact, more than half of each of the first two years' premiums is taken by charges over the term of the policy. The very heavy charges in the first two years arise principally from the additional charge on the capital units.

It is also convenient to re-express the individual charge figures as one overall global figure. For the example policy, the charges are equivalent to a deduction of approximately 20% from each of the premiums. That is to say, the combined effect of all the charges is the same as if 20% of each and every premium were deducted to meet the insurance company's expenses.

This is true provided the policy is kept in force for the whole term. If the policy is made paid up at an early stage, the effective proportion of all premiums taken in charges can be very much higher than 20%. For example, if the policy is made paid up after 5 years, the effective proportion of all premiums taken in charges becomes 35%.

Perhaps surprisingly, the 20% figure is approximately right for a wide range of initial policy terms. The effective overall charge on my example policy only reduces substantially at terms of well under 10 years. Of course, many insurance companies make additional charges for short-term policies.

If the additional charges on capital units are not incurred, for example by paying a series of single premiums, the overall charges reduce by approximately one-third.

Summary

I hope I have made the point that the level of charges is a very important consideration in choosing a policy. It is far too glib to say that what is of paramount importance is the investment performance. Of course, if one company could predictably achieve an investment return only a few per cent higher a year than its competitors consistently over the long term, it would come top of the league almost regardless of the level of its charges. However, such a return is very difficult to achieve over, say, a 20 year period. What is more, how is a potential policy holder to determine which company is going to do particularly well in the future?

3.2 AN INVESTMENT STRATEGY REVIEWED

Choosing an investment manager / life office to look after your money may actually be more difficult than choosing the investments. There are now more unit trusts available in this country than there are constituents of the FT-Actuaries all share index. Many of these are available through links with life offices for partners to invest their retirement annuity premiums in. Then, of course, there are the life offices' own unit-linked funds, perhaps several hundreds of them, and their with-profits policies. The choice is bewildering and any simple rule of thumb methods for choosing a suitable investment medium would certainly be very useful.

One of the more frequently quoted observations is that unit-linked funds tend to do better in the early years, soon after they are set up, than after they have been established for some time. My own calculations indicate that this may, indeed, be true for retirement annuity funds - but only for certain types of fund! Also, the effect is quite small.

An explanation of my calculations together with a summary of the figures is appended to this paper. The results appear to indicate that there is an additional return during the first year or so, ie the funds do have above-average performance. However, only managed funds and UK equity and fixed interest funds exhibit this effect. The other types of fund, such as property and the overseas funds, do not show any excess return. The figures are as follows:

Type of Fund	Additional Return During First Year
Managed	1%
U K Equity	2½%
U K Fixed Interest	2%
Property	—
Index-Linked Gilts	—
Deposit	—
International	—
North American	—

(Source: Martin Paterson Personal Pensions Survey)

Where a dash is shown above, the figure is not significantly different from zero (in the statistical sense). Some of the dashed figures were positive and some negative.

Possible Explanations

The conventional explanation for this effect is that when a fund is just starting up it is small and so the manager can more easily take advantage of any opportunities with which he is presented. Also, he can make substantial changes in the portfolio simply by redirecting new money, without the expenses of selling existing investments.

However, if this is correct, one would expect that new overseas funds would also outperform their more established competitors. Also, in the fixed interest markets the new fund has very little advantage. There is virtually no practical constraint on the volume of Gilts even a large fund might deal in and the dealing expenses are low. Yet, new UK Fixed Interest funds have a significant excess return.

Therefore, in my view, the "conventional explanation" simply does not account for all the observed facts. But are there any other plausible explanations?

One which has been put forward occasionally is that some companies might "hype" the returns of their new funds so as to get them off to a good start. This could be done, for example, by deliberately reducing the price at which the first few units in a new fund are sold or by channeling particularly attractive investments towards the new fund.

However, in order to explain the observed effects, one would have to attribute this highly unethical behaviour not just to a handful of companies but to a substantial part of the market. Therefore, I believe that this explanation must be incorrect.

Another explanation is that there may be some bias in the reported statistics. Presumably, if a fund has got off to a bad start the insurance company will have to take some action to try to correct the situation. In extremis, that fund may be closed to new entrants and a new fund started. The returns of closed funds are not shown in the tables. In any case, if the fund has performed badly initially, the chances are that relatively low premiums are presently being written. Consequently, the companies may not be too bothered about providing performance statistics for those funds and they may simply have to be omitted from the tables. One would expect this bias, if it exists, to exhibit itself in the more commercially sensitive funds, such as the managed funds, UK equity and fixed interest funds, and perhaps not to be apparent in the other funds.

If this is correct, then adjusted tables which included the defunct funds might show no true excess performance in the early years. This is an avenue for possible future research.

It is quite possible that all these explanations are true to some extent, rather than there being a single correct explanation. In the meantime, in the absence of a satisfactory explanation, perhaps one should accept the results as shown.

Can the Effect be Profitably Exploited ?
On the figures available, the excess return phenomenon has existed in the past. It is obviously still possible to exploit such phenomena without necessarily being able to explain them.

Nevertheless, the lack of an explanation does raise some doubts as to whether the phenomenon will continue in future. The additional return is really quite small and it may not be worth the risk of going to an untried fund. Moreover, the whole thing may possibly just be a result of bias in the reporting of the results.

I have examined above one well-known simple investment strategy to see whether it holds water. My own reaction is to remain extremely sceptical about this particular method for choosing investment funds and, by implication, about other, similar methods.

3.3 LOANBACKS

These days virtually all retirement annuity policies include some kind of loanback arrangement. Yet, the term is something of a misnomer. It implies to the policyholder that he can borrow back his own retirement annuity premiums if he wants to. The reality is somewhat different.

For a start the retirement annuity policy cannot be used as security for a loan (see S226(2) of the Taxes Act). This means that the policyholder will usually have to provide security in some other form. Also, the loan must be on commercial terms. Indeed, when one insurance company chose to lend on clearly uncommercial terms a few years ago, this was so badly received by the Revenue that the company was forced to refund the premiums to its policyholders and cancel the policies.

Many insurance companies do not, in any case, offer loans directly out of their funds. It is much more common for the loans to be advanced by a friendly bank, the insurance company providing little more than an introduction. Given that the banks will apply their normal lending criteria, that some form of security is normally required and that the loans will be on strictly commercial terms, one wonders whether these loans would not be available in any case, even without the retirement annuity policy.

The usual tax reliefs apply to these loans provided they are for a qualifying purpose, ie house purchase (up to £30,000 at present) or for business use. The interest must actually be paid, not simply rolled up with the loan, for tax relief to apply.

Secured Loans
Most banks and insurance companies require outside collateral. Some will accept for this purpose a first or second charge on real property or on a portfolio of stocks and shares.

It is worth noting that an insurance company taking as security part of a portfolio of stocks and shares will normally require that the portfolio be transferred into its nominee company's name. It may also seek to control the investment of the portfolio to some extent.

The interest rate in most cases is approximately 2% - 3% pa above base rate.

Unsecured Loans
Some of the clearing banks are prepared to lend under their "professionals schemes" without security in some cases.

Their definition of "professionals" includes accountants, actuaries, architects, barristers, dentists, doctors, etc.

The loan has normally to be used for the purchase of a share in a practice but they will consider loans used for other purposes on an individual basis. It is not clear that a general use, e.g. to provide working capital within a partnership, would always be within their guidelines.

The loan can be for a maximum term of 25 years. Since the earliest the policy can normally mature is age 60, the minimum age for these loans appears to be 35. This may be too late for many young partners seeking to buy their way in.

The loan can be on an interest-only basis with the capital being repaid when the partner retires, usually out of the proceeds of his S226 policy. The loan can be up to the value of the S226 premiums already paid to certain insurance companies participating in the scheme plus up to 15 years' future premiums.

One condition of the loan is that premiums under the associated S226 policy must be continued until retirement, otherwise the loan may be called in. In principle, this might cause a substantial problem for a partner who leaves the partnership, subsequently enters pensionable employment and is thus debarred from making the necessary contributions.

The interest rate under this scheme at present is 2% pa above base rate.

4. SELF-INVESTED SCHEMES

There are three main reasons why partners might prefer a self-invested pension scheme to an ordinary insured scheme:

(1) They might simply fancy managing their own investments.

(2) They might want their pension fund to invest in property for leasing to the practice.

(3) In some cases the charges under self-invested schemes can be substantially less than under ordinary insured schemes.

These reasons may be coupled with a general feeling that they want their pension fund to be under their own control as far as possible. Many professional partnerships will by now have experience of advising client limited companies with small self-administered pension schemes and they may wish to set up similarly flexible arrangements for themselves.

4.1 PROPERTY AS AN INVESTMENT

Provided that suitable safeguards can be devised, many partnerships must wonder why their retirement annuity funds should not be used to capitalise their own businesses rather than being invested out of their reach.

Of course, it would be quite outside the spirit and scope of the legislation for their annuity funds to be employed directly in their practice. Nevertheless, there may be perfectly sound investments for their fund which might indirectly benefit the partners' business. In particular, for their annuity fund to purchase property which can be leased to the partnership on commercial terms may be an excellent, secure investment. There are a number of specific advantages to such an arrangement for both the fund and the partnership:

The annuity fund would have a secure long-term property investment with (hopefully) excellent tenants.

The partnership would have a secure landlord and, presumably, the property they wanted - without having working capital tied up in it.

There could be scope for significant savings in administration costs since the partnership would have to administer the building in any case and could do this on behalf of their fund.

Partnership Succession
There is a further, more subtle, reason for considering holding the partnership property within a pension fund. This is to do with the partnership succession.

It can be difficult enough for a junior partner to fund his share of the partnership's working capital. The problem can be much greater if he has also to fund a share of a major fixed capital item such as the partnership's property. Indeed, the demands on his limited resources may prevent him making any provision for his eventual retirement. By placing the property in a separate pension fund, the firm's fixed capital can be separated from its working capital. The junior partner can then afford his pension contributions because these are also effectively funding his share of the partnership property at the same time.

Types of Self-Invested Scheme
To meet this demand for a self-administered partnership pension fund within the present legislation, two methods have been developed:

One method involves using the services of a suitably cooperative insurance company. The company sets up a segregated retirement annuity fund within its overall portfolio specifically for the partnership.

The other method involves the partnership in setting up a "private" friendly society specifically to transact some or all of the partners' retirement annuity business.

These two approaches are outlined below.

4.2 INSURANCE COMPANY SELF-INVESTED SCHEMES

A number of insurance companies are now prepared to set up a segregated retirement annuity fund for one or more individual policyholders, for example the partners in one firm. In principle, the insurance company hands over the investment control of this fund to the policyholders. In practice, it is somewhat more complicated than that.

The segregated fund forms part of the life office's overall portfolio. The partners' stake in the fund is in the form of an entitlement under a unit-linked policy. The fund is therefore subject to the restrictions of the insurance company regulations upon the type of asset which can be included within a unit-linked fund. Also, the insurance company may not consider some types of asset suitable for its portfolio. The main embargoed investments are unquoted securities, residential or foreign property and loans secured thereon.

A more subtle problem arises because the investments are held in the name of the insurance company and are therefore aggregated for some purposes with its other investments. For example, if the insurance company's overall investment in a particular company exceeds 5% it must report that stake and at higher percentages the City Takeover Code may come into effect. Clearly, the insurance company would not wish to have its hand forced by the action of one of its segregated funds just tipping it over the limit. One large insurance company presently has a list of roughly a dozen individual companies in which its segregated funds are not allowed to invest. A further dozen or so companies may only be dealt in with the insurance company's prior permission.

The insurance companies will generally insist that the investments of the segregated fund are managed by a suitably qualified person, such as a stockbroker or licensed dealer in securities. Transactions must generally be made through the insurance company. For example, contract notes must be sent to the insurance company which will settle with the broker. The investments will be registered in the insurance company's name.

The investment managers will have to ensure that sufficient ready cash is available from time to time to meet the insurance company's charges. Also, it will generally be necessary to have available the full capital value of a partner's fund when he retires. This is because pensions cannot usually be paid directly out of the segregated fund on a year to year basis.

Nevertheless, although there may be some paperwork involved, the constraints on investment are not all that significant in practice.

In most other respects, the self-invested fund works in exactly the same way as any other unit-linked retirement annuity policy.

One point worth noting is that, in the event that the life office becomes insolvent, the partners' fund will be at risk. This is not a wholly insignificant point since some of the companies transacting this fairly unconventional type of business are comparatively small and newly established. Also, the premiums will be subject to any levy under the Policyholders Protection Act. This may seem anomalous, since the insurance company is not taking on any significant risk in respect of the fund, yet the partners are taking on some risk in respect of the insurance company.

4.3 FRIENDLY SOCIETY BASED SCHEMES

There are two types of institution allowed to accept partners' retirement annuity premiums, namely insurance companies and friendly societies. Whilst it would be quite out of the question for a partnership to set up its own captive insurance company, it is an extremely intriguing and quite practicable proposition for the partners to set up their own "private" friendly society.

The friendly society can transact the partners' retirement annuity business in the usual way and with all of the usual tax privileges. The annuity contracts are, in all important respects such as limits on qualifying premiums and tax-free lump sums at retirement, identical to those issued by insurance companies. The friendly society's investments are not subject to tax, provided the necessary approvals can be obtained.

In a Nutshell

This arrangement enables partners to have control through their friendly society of their investments. The relationship is even more direct than investment through an insurance company's segregated fund. The friendly society can invest in property which can be leased to the partnership. It can also provide up to 100% loanbacks on a secured basis. At the same time, the costs can be much lower than for an insurance company's segregated fund.

What is Involved in Setting Up a Friendly Society ?

For a firm to set up its own friendly society there need to be at least seven partners in the firm (including salaried partners). Not all the partners have to join the friendly society but there have to be at least seven contributing members. They have to meet, resolve to form the XYZ Friendly Society and adopt a suitable set of rules. These are then sent to the Registrar of Friendly Societies with an application for registration. A suitable system of financial accounting and control will also need to be established at this time since the Registrar will need to be satisfied with this before agreeing to the Society's registration. Any tables of rates within the rules have to be actuarially certified.

At the same time, an appropriate retirement annuity document has to be drawn up and submitted to the Revenue for approval.

The friendly society is run by its managing committee which in these cases is normally composed of members of the partnership. The managing committee has to be selected at the stage of applying for registration.

Once registered, the Society is in operation and can transact retirement annuity business for its members, ie the partners in the firm. They may choose to utilise some or all of their retirement annuity relief in premiums to the Society. Any existing contracts with an insurance company need not be discontinued, unless this is desired.

Although seven members are required to set up a friendly society, it can still continue to operate if the numbers fall below seven. The minimum practical number, though, is three.

Friendly societies are governed by the Friendly Societies Act 1974 and by a whole host of case law going back many years. Many of the most important cases were decided last century or early this century. To the practitioner used to the flexibility of the Revenue's discretion when dealing with pension schemes under the FA 1970, the difference of approach can be quite startling.

Permitted Investments

There are, in principle, no limits on the amounts which can be invested in property (including the partnership's property) or in loans back to the partners. Loans to partners have to be secured by a first or second charge on property.

The main areas of permitted investments are:-

* Property.
* Loans secured on property.
* U.K. equities, including investment trusts.
* Fixed interest securities.
* Index-linked Government stocks.
* Authorised unit trusts investing in the U.K. or overseas.

The investments (other than in property) are subject to the terms of the Trustee Investments Act 1961. The main effect of this is to limit the maximum proportion of the funds which can be invested at the outset in equities and equity unit trusts to 50% of the total. The balance has to be invested in fixed interest securities or, via the fixed interest part of the fund, in property. Loans to partners count towards the appropriate fixed interest investments. This restriction applies to the investment of premiums and investment income but there is no need to continually "re-balance" the portfolio.

The investments can form a common pool or each partner can have his own individually-managed fund within the society. It is up to the partners to decide how to organise things. But if they wish to keep the paperwork to a minimum, they will presumably limit the number of funds that have to be run.

Administration

In addition to the managing committee, the society will have trustees to hold the investments. In most cases the trustees will be members of the managing committee. In addition, the society needs a Secretary and a Treasurer whose jobs are to keep the society's records and books of account.

The society will issue its members with their policies and with the necessary form SEPC to obtain tax-relief on the contributions. If desired, there is no reason why the policies should not be 'clustered', ie each partner could have several policies each for a part of his total share in the fund.

The society normally operates a simple accumulation fund. Once a partner retires and wishes to draw his pension, his share of the fund is transferred to an insurance company's substituted annuity policy. The insurance company will then be responsible for calculating the partner's tax-free lump sum and for paying his pension.

At present, the Registrar requires the submission of simple summary statistics for the society to be made on a quarterly basis.

On an annual basis the society will have to:

* Hold an annual general meeting of its members.
* Have the accounts audited.
* Make a full return to the Registrar.

In addition, unless exemption can be obtained, an actuarial valuation of the society's assets and liabilities will need to be made every three years. The first such valuation is due approximately three years after the society's registration.

The way the society operates is governed by its rules. These can be changed at a suitably-convened meeting of the members. The rule amendments then need to be sent to the Registrar for registration and are not valid until this has been done. If the rule amendments bear upon the working of the S226 policy, the Revenue's agreement is also required.

Comment

The legislation under which these friendly societies operate was clearly never intended for this purpose. They are therefore in some respects rather cumbersome. The investment constraints, intended to protect members of the public investing with friendly societies, are clearly not appropriate to this sort of society providing long term retirement annuity business for a small group of partners. (Whether it is still appropriate to constrain any friendly society in this way is a moot point.)

The attitude of the Registrar and Inland Revenue towards these schemes is somewhat ambivalent. No undue tax reliefs are obtained by these schemes; they are simply a more convenient and efficient way of organising the partners' pensions. So long as they are used in this way and are not abused, there is no great threat that the authorities will put an end to them.

5. ALTERNATIVE METHODS FOR CONSIDERATION

5.1 SERVICE / SUBSIDIARY COMPANIES

Some partnerships have found it worthwhile to set up limited companies, owned by the partners, to conduct a part of their business. For example, a firm of accountants might set up a management consultancy company.

This company will then charge its clients for its work and may well employ various members of the partnership. Their remuneration from the company will be taxable under Schedule E. It will therefore be possible for the company to establish a scheme approved under FA 1970 to provide pension benefits for those partners who are employed by it.

In some cases partnerships have set up service companies whose main function has been simply to employ the staff within the partnership.

Whilst this is all perfectly proper, the Revenue will no doubt wish to be satisfied that :-

(i) Each partner's remuneration from the company bears a reasonable relationship to the work that he actually does for it. One may imagine that they will exercise particular care in considering an internal service company.

(ii) The company's charges to clients relate only to work done by the company, not by the partnership.

If these hurdles can be overcome, there may be some advantage to the partners, eg the limits on contributions and the constraints on investments are generally less severe for a FA 1970 scheme than for the usual S226 pension arrangements.

5.2 RESIGNATION & RE-EMPLOYMENT

In principle, there is no reason why a partner should not step down from the partnership and be re-employed by the firm. He may then be included within a suitable scheme approved under the FA1970. Of course, he almost certainly will not wish to suffer the change of status but, if the tax incentives are sufficient, he may be prepared to consider it.

What is crucial in considering this is the level of benefits which can be provided through the pension scheme. If his service as an employee is only one or two years the maximum benefits will be trivial. However, it is quite possible that he had a period of employment with the firm, perhaps as a salaried partner, before serving as an equity partner. The Revenue may allow this service to be taken into account in calculating his maximum entitlement under the pension scheme. However, they are unlikely to allow their 'uplifted 1/60ths' scale to be used. Also, the earlier service might be disbarred if, for example, the partner was then a member of the firm's pension scheme and received a refund of contributions when he left it. Prior consultation with the Superannuation Funds Office is clearly desirable.

5.3 TRUST FUNDS

S226(5) of the Taxes Act allows a trust fund to be set up into which partners may pay their retirement annuity premiums. It must satisfy two important conditions:

First, it must be "for the benefit of individuals engaged in or connected with a particular occupation... ".

Second, it must be established by a body "representing a substantial proportion of the individuals so engaged in the UK".

So, for example, it is conceivable that the Institute of Actuaries could establish such a fund for its members.

The trust fund, and the premiums paid to it, would be eligible for all the usual tax reliefs associated with S226. It is even conceivable that it could have separate sections within it for separate partnerships or individuals, ie each partnership could have its own segregated fund. There would be very few constraints on its investments. It would be relatively easy to administer. In short, such a fund has the potential for providing an almost ideal pensions vehicle for partnerships.

And yet virtually no such funds have been set up. Presumably, professional bodies have even less time available for discussing pensions arrangements than do their members. So, for the time being at any rate, for the majority of partnerships this route is not viable.

5.4 PARTNERSHIP ANNUITIES

It is, of course, open to the remaining partners simply to provide an annuity to their retiring brethren out of the practice's income on a year to year basis.

The main disadvantage from the retiring partner's point of view is that he relies on the continued prosperity, or at least solvency, of his former partners for his livelihood.

From the remaining partners' point of view the requirement to continue making payments to a former partner may be onerous without the benefit of an accumulated fund. Also, they may not wish to take the chance that their former partner might live to too ripe an old age. Consequently, they may wish to limit the term of the annuity to say 10 years. This effectively transfers the mortality risk back to the retiring partner.

The legislation is reasonably tidy, provided various formalities are complied with. So the annuity will be regarded as taxable income for the retiring partner and as a business expense for the remaining partners.

What is, of course, lacking from such an arrangement is the savings element. It is all operated on a "pay as you go" basis without any prior setting aside of contributions or the benefit of their accumulation within a tax-free fund.

6. ROOM FOR IMPROVEMENT

Successive Governments have sought to encourage individuals' saving for retirement since it is clearly desirable that they should not be a burden on the State in their old age. In the meantime their savings will form a useful capital base for the country. The Governments' chosen method has been to provide tax incentives for savings schemes which satisfy certain restrictions laid down in the various acts. These are aimed at limiting the dates at which the savers can withdraw their savings to around their retirement age and ensuring that the bulk of the savings have to be withdrawn in the form of life annuities. In addition, the savings scheme has to be managed by an insurance company or friendly society.

It should be stressed that, from the individual's point of view, it would be crazy for him to invest in such a restricted form, were it not for the tax-incentives. The question may, therefore, be asked whether the present arrangements really do encourage saving for retirement.

If some of these constraints could be relaxed, it might be just as attractive for the individual to save for his retirement even if some of the tax-reliefs were reduced at the same time. The Government might, therefore, achieve its apparent aim of encouraging retirement provision just as effectively, but at less cost to the Exchequer.

On a more general note, one might wonder whether the entire present tax system, with its comparatively high tax rates coupled with relatively generous exemptions, is sensible. Certainly, it provides a satisfactory intellectual challenge (not to say a good living!) for the advisers guiding their clients through the tax maze and trying to make the best use of those exemptions for them. The financial sector seems to be able to attract many of the brightest of the young generation leaving our universities, at the expense of manufacturing industry. Surely, this constitutes a considerable waste of talent for the country as a whole? This paper is, however, not the place for a detailed review of the tax system.

Within the constraints of the present system, perhaps the most surprising limitation on retirement annuities is their lack of transferability. The Inland Revenue does not allow a partner to transfer his retirement annuity fund from one insurer to another - no matter how badly the first insurer may be performing. At a time when the Government is committed to the greater portability of pensions arrangements this is a most curious state of affairs.

It is all the more curious when one considers that S26 of the FA 1978 already provides the legislative framework for this transferability. No primary legislation, or even regulations, is required. At present, however, the Revenue will not approve policies that have a transfer clause in them (apart from the usual "open market option" which applies only at retirement). All that is required to allow such transfers is a change in the Revenue's practice.

7. CONCLUSIONS

Partnerships spend a lot of money on their pensions and they can benefit substantially by making the time to plan carefully what they are doing.

It is in their interests to be concerned about reducing the deductions the insurance companies make from their premiums. One simple way of doing this is to take out single premium policies.

They may benefit by sacrificing some of their independence and purchasing their policies as a group.

Self-invested schemes are now available which may be well suited to the partnership's needs.

If the fund is to be invested mainly in property, the friendly society route may well be the best.

If investment of a large part of the fund on the Stock exchange is anticipated, the investment constraints on an insurance company's segregated fund will be less onerous than for a friendly society. This has to be balanced against the possibly higher charges of the insurance company arrangement.

Because it is not possible at present to transfer past contributions into one of these funds, it may be worth setting up such a scheme well before it is anticipated that the self-invested option will be required to be used.

There are more schemes available, and of greater sophistication, than ever before. Consequently, the potential rewards for making the right decision are greater than ever. And vice versa.

8. REFERENCES

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APPENDIX FUND PERFORMANCE STATISTICS

The statistics analysed from the Martin Paterson survey are calculated as follows.

For each fund, the return over one year periods is calculated allowing for reinvested income where appropriate and for the annual management charges. The returns used in the paper are taken from the October 1985 survey. They are therefore all for periods ending on 30th September. Where a fund has not been valued on 30th September the price ruling on that date has been taken.

The returns I have used are all for the first complete year commencing 1st October after the fund's inception. In some cases this will mean that the return is for a period commencing up to a year after the fund commenced. On average the delay is around six months. The new funds considered are those commencing after 1st October 1977 and before 1st October 1984.

The funds in the survey are classified into broad categories, eg managed, UK equity, etc. For each year all the funds in each class, new and old, are given their percentile rankings. These percentile rankings are similar to ordinary rankings except that they are normalised so that they are always on a scale of 0 to 99 regardless of the number of funds in the class in that year.

For example, if there were only four funds in one year in a particular class, the top fund would have a ranking of 0, the bottom fund would be given a ranking of 99, and the middle funds would have rankings of 33 and 66 respectively.

This system thus enables the new funds' returns to be compared with the established funds in the same class over the same period. At the same time, by using the percentile rankings, no particular weight is given to years when the returns in general were very high or very spread out.

The average percentile rankings for the new funds within eight of the classes are set out below:

MANAGED FUNDS	UK EQUITY FUNDS	PROPERTY	FIXED INTEREST	INDEX LINKED	DEPOSITS FUNDS	INTERNAT FUNDS	NORTH AMERICAN FUNDS
40.07	39.28	49.93	36.50	52.69	49.73	47.43	54.04
55	67	42	52	36	55	65	26

The figures below each average are the number of new funds in each of the classes considered.

An average of 49.5 would be expected if there were no excess return. A lower percentile ranking implies an excess return compared with the average. Thus the excess return on managed funds is equivalent to 9.4 percentile points, ie about one-third of the difference between the median and the upper quartile (25 percentile points)

The average difference between the median and upper quartile returns for the relevant period may be calculated and this can be used to turn the excess percentile points into a more meaningful estimate of additional return. For example, the average difference between the median and upper quartile performance of the managed funds over the seven years was around 3.1 % pa. Using this the excess return for managed funds may be estimated as follows:

$$\frac{9.4 \times 3.1}{25} = 1.2\%$$

This figure, around 1%, is the extra return one might expect on average by investing in a new managed fund rather than an established one.