BUDGET Newsletter

May 2006

Introduction

Britain and the global economy appear to have come through the period of concern in late 2004/05, as a result of which stock markets in every part of the world are moving ahead strongly. 2005 was an outstanding year for investment returns and only the extremely cautious, limiting themselves to cash, will have been disappointed with the results.

All the indications are that 2006 will continue its strong recovery but it should be noted that the risks that the global economy faced 18 months ago have not moved away.

Personal debt, the reliance on the US consumer and deteriorating government finances will ensure that stock markets continue to be a bumpy ride. There is a saying that investors should sell in May and go away (until October) and with the strong gains of the last six months, this may be a sensible strategy.

In this environment, the Chancellor introduced the Budget in March 2006 in a speech which was long on self-congratulation but had very little substance. Everything of importance was in the accompanying budget notes which left the financial services industry and legal professionals scratching their heads at some of the decisions particularly on:

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Pensions

The government introduced the pension simplification rules and legislation as long ago as December 2002 and there were two highly positive features. Firstly the ability to invest in a wider range of assets such as residential property and secondly the ability through careful management and planning, to enable your pension fund to pass down to the next generation to fund their future needs without inheritance tax.

It was only last December that the ability to invest in residential property was suddenly excluded and then, a mere 15 days before A-Day, the government changed the rules to stop the cascading of the pension assets down the generations. Even though they've been trumpeting it over for the past few years.

Having been one of many in the industry to send a response to their consultation document a year ago, they neither acknowledged it, nor took any notice. Should we be surprised? I think not. The legislation is so poorly drafted that some have expressed concern that a pension in trust could be termed an unauthorised payment and be taxed at 55%.

Trusts

If that was a shock to the system, they had more planned. Budget Note 25, harmlessly entitled 'Aligning the Inheritance Tax Treatment for Trusts' introduces draconian changes to Trust law and will require the re-writing of millions of Wills.

In the past, only Discretionary Trusts had been effectively chargeable transfers on settlement and subject to a periodic 10 yearly tax charge. Now with the new rules almost every Trust will be subject.

Every couple on a second marriage, wanting to protect their assets for their own children but giving the surviving spouse a life interest runs the risk of losing the spouse's exemption.

Parents taking out a life plan to protect their family in the event of untimely death could be faced with a 10 yearly tax charge on the plan, just for being prudent. A word the Chancellor has bandied about, but doesn't fully understand.

These are just two of many examples of Trusts which will be affected.

These new rules have been poorly drafted and have been introduced without consultation. The government stated emphatically that this tax is only for the super rich and will generate no more than £15m: they have also claimed that IHT is *only* paid on death. They either don't know their own tax laws or they're lying: which is worse?

In the main our advice is to wait until the legislation is finalized before amending your Wills, but that does presuppose the most important factor, which is to live until then. There are some categories of people such as the first example above, who should consider change.

Venture Capital Trusts

After two years of 40% tax relief and investment in AiM and other funds, the new rules will restrict but not kill the market. There are three key changes: the first two are a reduction in tax relief to 30% and an extension to the holding period from 3 to 5 years. These won't pose too great a problem but the third, a reduction in asset valuation of the companies being invested in from £15m to £7m, will make it more difficult for the VCTs to find qualifying investments.

Inheritance Tax Planning in a post BN25 World

It is too early to start making plans because we don't know what the final form of the legislation will be. While there may be modifications at the margins, it appears that the Treasury are hell bent on introducing the legislation and unless there is a revolt in the Commons, it will be on the statute book by late summer.

What you can do is to write to your local MP, especially, if they are Labour, to lobby for them to vote against pending consultation. If you want some wording ideas please let me know.

On the assumption that the basis of the legislation is introduced intact, then Discretionary Trusts (DT), valued at lower than the nil rate band, may become more appealing and the use of AiM and woodlands investments being settled in to DTs could take on a new interest.

Remember that when one door closes another normally opens and with any luck a new Government might return to the belief that Trusts are a legitimate basis for managing family affairs.

INVESTMENTS

I mentioned earlier that UK investors may well sell in May and go away, but for those who are prepared for a greater level of risk and who monitor their investments, the following specific sectors merit consideration:

Japan
The Nikkei 225 has climbed above 17000 for the first time in six years, and growth is such that interest rates may start to rise (above 0%). While this market has grown by over 100% in the last few years, it's still way below the 39000 reached in 1989. It is time for any broadly diversified portfolio to have a percentage in Japan.

Emerging Markets
Whether you look at China, India, Latin America, or Russia and Eastern Europe, markets have shot up. Can it continue? The main concern is that the regulatory environment is not as strong as the UK or US and these markets will be affected most by any political bombshell in the Middle East.

Commodities
Gold is the best example and has breached the $600 per oz, but from uranium to sugar, prices are rising. Will it continue? Many observers believe that after decades of low commodity prices, there is a shortage of supply and with energy, especially oil and gas, these are systemic price rises which are going to continue. There are funds which can enable you to take advantage.

Property
Prices in the UK appear to be under some strain but there are global opportunities for those prepared to take extra risk.

Europe
While the economies, especially Germany, are now in a strong growth phase, there are imbalances caused by the single interest rate. If the ECB starts raising interest rates later in 2006 to take account of Germany's growth, what effect will it have on the poorer performing economies such as Italy?

We must be careful because everything, except bonds, seems to be rising inexorably that the risk profile of our investments doesn't get uncoupled from our own views. Cash and fixed interest, though performing poorly at the moment, are an integral part of any portfolio.

RISK

On our website, we have a section entitled risk and specifically a questionnaire which you can complete to measure your own risk profile.

Times have changed and the coarse measurement of low, medium and high needs to be reassessed to reflect the different reasons for investment, eg pensions or shorter term such as school fees, and the degree of diversification acceptable.

We would encourage you to complete the questionnaire on our website so that we can check that your portfolio reflects your attitude.

WHO ARE MARTEC?

We are independent financial advisers, directly regulated by the FSA, specialising in sophisticated investment and tax planning solutions for investors, professional companies and employees.

Technical excellence is our objective, supported by the qualifications held by Managing Director Alistair Thomson and assisted by a dedicated team of advisers and administrative staff.

Since entering the financial services industry in 1987, he has built on these to include the Advanced Financial Planning Certificate and membership of the Society of Trust and Estate Practitioners (STEP). He is also a Fellow of the Assoc of International Accountants.

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