



The basics

Adam Smith put forward in his 1776 publication "The Wealth of Nations" that tax systems should have certain characteristics. These can be summed up as follows:

A tax system should be equitable, certain, convenient and efficient. I would certainly like the UK tax system to have these characteristics. Or even a couple of them.

There are many works by respected authors that describe what a good tax system should look like. The above list of four is a pretty good starting point.

In Mr Darling's 2009 Budget we learned that a new highest rate of 50% is to apply to those with income in excess of £150,000. These are probably successful individuals but I would hardly class them all as extremely wealthy. We also found out that this country's indebtedness was likely to be somewhere between £150 billion and £200 billion and one of Mr Darling's master strokes for dealing with this record busting deficit was to raise a whole extra £2 billion (a number which has itself been questioned) through the above measure. We also worked out that the marginal rate of income tax for those with incomes of just over £100,000 was in fact 60% and not 50%.

The measures designed to discourage contributions to pension plans are well publicised elsewhere. This is another masterstroke. Over about 15 years the UK has moved from being a leader in Europe in pension provision to a position at least half way down the league but potentially much worse than that, depending on whom we include in the league and what exactly we measure. The government has spent a huge amount of money designing, promoting and launching stakeholder pension plans and is planning to do the same with Personal Accounts. This is because at some primitive level they understand that people who are due to retire over the next generation are going to have incomes in retirement far lower than their expectations and that they will suffer this expectation gap for a long time because we are all living too long, and that during that period those that are retired will make up a larger and larger proportion of the voting public. So Mr Darling has decided to bring in measures that will discourage decision makers from continuing with well funded pension schemes.

I remember in the dim and distant past, 2005, when the Inland Revenue explained how from 6 April 2006 (A Day), eight tax regimes would be replaced by one and pension funds would be able to be used to own residential property. Unfortunately, just before A Day, new rules were announced that effectively closed this window for most clients before it was opened.

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Even further back, in 1998, Gordon Brown announced a new way of taxing capital gains. The idea imported from America and researched by Ed Balls was to tax those who held assets for the long term at a lower rate than those who made their gains in a smaller period. Some commentators suggested that this was the current government's single most successful measure in encouraging entrepreneurs. So in 2008 this entire system was exterminated and replaced with a scheme that taxes most gains at a flat rate of 18%.

If ever there was a time when we needed entrepreneurs surely 2009 is it. So the government has decided to increase income tax for those earning over £150,000 and for those around the £100,000 threshold and decided that long term investment should not be rewarded by the tax system.

As I have mentioned before, one of the most confident predictions I can make is that the tax burden is going to have to rise. The level of public debt is staggering. The only ways to deal with it are 1.Cuts to public services, 2.Inflate the debt away, and 3.Increase taxes. 1 and 3 are racing certainties with 2 not far behind. That increased tax burden will also fall disproportionately on those with higher assets and higher incomes than average. The unpalatable measures we have seen thus far will raise so little money when compared with the size of the problem that they are almost meaningless. The exact methods used to extract more tax are hard to guess accurately but do not rule anything out – income tax, capital gains tax, inheritance tax, VAT and many others are all candidates. This general prediction coupled with the fact that tax changes are not always well thought through increases the relative attractiveness of tax protected investments and of undertaking all sorts of tax planning sooner rather than later. This will be covered in the normal review process but if you have any particular queries do not hesitate to contact me or one of my colleagues.

I appreciate that there is also a number 4 – default on the debt. While this country's record on sovereign default is excellent, and I am not suggesting that this will change, there are many other countries, not just in Eastern Europe, who have defaulted. Do not rule it out entirely for some closer European neighbours. Your only sovereign debt exposure is to the UK, which has not defaulted for over 500 years.

As well as talking about tax, Adam Smith also details the basics of capitalism, which he argued required four inputs. These are raw materials, labour, intellectual property and financial capital. When these four are mixed in a free market economy a good or service is sold for more money than it cost to produce. The organisation that supplied the good or service then banks the sale proceeds and the provider receives his proportionate reward either in the form of dividends or an increase in the value of his share in the enterprise or both.

You as investors are owed a positive expected return on your capital. I continue to believe that investment in equities (and property) has a higher expected return than other major asset classes. Nothing that has happened in the last 12 months leads me to suppose that anything at the most fundamental level has changed.

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