

Letting the Tax Tail Wag the Investment Dog

Throughout the life of an investment portfolio many decisions have to be made. Some of the most emotive of these revolve around actions that crystallise or create a tax liability.

No one likes to pay tax. In general we accept it as a necessary evil, but very few investors want to pay tax if it is at all avoidable. However, we must be careful not to let tax become the over-riding issue for a portfolio. To make investment decisions based predominantly on the tax liability that will result can severely affect a portfolio's ability to meet its investment goals.

There are two taxes that investments as a whole suffer, Income Tax and Capital Gains Tax.

Income Tax

Income tax is paid on dividends, interest payments, income paid from pensions and gains made on investment bonds and offshore bonds. Very few assets do not generate an income tax liability, although clearly an investment that provides a lower level of income will result in a lower income tax liability than one that pays a higher level of income.

This information can be used to limit the tax liability, but we should be careful in taking it to far. For example, as a rule fixed interest funds pay a higher yield or income than equity funds. To reduce income tax it would make sense to hold a proportion of the fixed interest assets in an income tax efficient wrapper such as an ISA.

It would, however, not make sense to hold equities instead of fixed interest in order to save income tax. The two assets have very different attributes and levels of volatility. The ratios in which they are chosen within a portfolio will govern the level of volatility that the portfolio is likely to endure and thus this choice should be determined by the investor's aptitude for investment risk.

Buying equities instead of fixed interest will increase the volatility and risk associated with the portfolio. The quite small amount of income tax probably saved is unlikely to offset the agitation endured by an investor from the additional loss that the portfolio would suffer in the inevitable periods when the stock market takes a downward turn.

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Capital Gains Tax (CGT)

Capital gains tax is more often a consideration than income tax when considering investment portfolio changes. It could, in a twisted way, be considered a 'nice' tax to have to pay, as it only arises when a significant profit has been realised.

The impact of capital gains tax on a portfolio is most commonly felt in larger stock broking portfolios. Unlike unit trust fund managers, stockbrokers are not exempt from paying CGT. Thus, any trades that they make which result in a profit will trigger a capital gains tax liability if the gain, together with other gains made that tax year, exceeds £9,200 (the capital gains tax allowance for the tax year 2007/8).

If the broker is under instruction not to place deals that will trigger a CGT liability, as many of them are, this will severely hamper the broker's ability to do what is the very core of the broker proposition. Leaving aside our own doubts about the value that a stockbroker adds to a portfolio, an investor who uses a stockbroker does so primarily because they believe that the broker can spot opportunities and mistakes in the market and exploit them.

If, however, the broker's hands are tied as a result of instructions regarding the limitation of CGT, how then is he supposed to carry out his role? And the effects are twofold. Not only might the broker find he is unable to purchase what he believes to be prime investment opportunities due to lack of liquidity, he may also find that he is unable to sell stock when he believes the time is right because the profit and thus the tax would be too high.

Even outside of stock broking portfolios it is not unheard of for a tax professional to advise not to sell an asset because the tax implications are too high, better to sell when less profit will be realised.

Clearly this is a fairly ludicrous state of affairs and it is a policy that virtually dooms a portfolio to mediocrity.

The same implications apply, to a lesser extent, to our clients portfolios. Occasionally an asset allocation adjustment may result in a capital gains tax liability, although we will always try and ensure that any available allowances are utilised. By not re-balancing due to tax consequences, and by not taking profits on a reasonably regular basis, we risk the portfolio becoming locked in a spiral that leads it ever further away from the original asset allocation devised for the portfolio, which in turn reduces the probability that the portfolio will meet our investors requirements and goals.

There is no getting around the fact that paying tax is an unpleasant experience for most people and we will always endeavour to reduce as far as practically possible the tax burden arising from an investment portfolio through judicious use of tax wrappers and allowances. However, we strongly advocate that there will be occasions where paying the tax in order to allow a strengthening of the portfolio is much preferable to saving tax and allowing the portfolio to weaken.

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