Section 1

The UK financial services industry

Introduction

Section 1 begins by providing a broad introduction to the functions of the financial services industry and to the institutions that make up the industry.

The impact of the government on the development of financial services is now greater than it has ever been: some aspects of the involvement of government are considered in this section (ie taxation and social security). Regulation of the industry is considered in Unit 2.

Section 1 covers parts 1 and 7 of the syllabus for Unit 1, ie the purpose and structure of the industry and the taxation and social security systems.

1.1 The functions of the financial services industry

The existence of money is taken for granted in all advanced societies today – so much so that most people are unaware of the enormous contribution that the concept of money, and the industry that has developed to manage it, have made to the development of our present way of life.

In earlier civilisations, the process of bartering was adequate for exchanging goods and services: a poultry farmer could exchange eggs or chickens for carrots and cabbages grown by a gardener. In modern society, people still produce goods or provide services that they could, in theory, trade with others for the things they need. The complexity of life, however, and the sheer size of some transactions make it virtually impossible for people today to match what they have to offer against what others can supply to them.

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What is needed is a separate commodity that people will accept in exchange for any product, which forms a common denominator against which the value of all products can be measured. These two important functions (defined technically as being a medium of exchange and a unit of account respectively) are carried out by the commodity we call money. In order to be acceptable as a medium of exchange, money must have certain properties. In particular it must be:

- sufficient in quantity;
- generally acceptable to all parties in all transactions;
- divisible into small units, so that transactions of all sizes can be precisely carried out;
- portable.

Money also acts as a *store of value*. In other words, it can be saved because it can be used to separate transactions in time: money received today as payment for work done or for goods sold can be stored in the knowledge that it can be exchanged for goods or services later when required. To fulfil this function, money must retain its exchange value or purchasing power and the effect of inflation can, of course, adversely affect this function.

Notes and coins are legal tender, ie they have the backing of the government and the central bank, but money comprises much more than cash. It includes amounts held in current accounts and deposit accounts, and other forms of investments.

The financial services industry exists largely to facilitate the use of money to carry out these main functions. It 'oils the wheels' of commerce and government by channelling money from those who have a surplus, and wish to lend it for a profit, to those who wish to borrow it, and are willing to pay for the privilege (this is described in more detail in Section 1.1.1). Of course, the financial organisations want to make a profit from providing this service and, in the process of so doing, they provide the public with products and services that offer, among other things, convenience (eg current accounts), means of achieving otherwise difficult objectives (eg mortgages) and protection from risk (eg insurance).

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1.1.1 Intermediation

In any economy there are surplus and deficit sectors. The surplus sector comprises those individuals and firms that are cash-rich, ie they own more liquid funds than they currently wish to spend. These want to lend out their surplus funds to earn money. The deficit sector comprises those who own fewer liquid funds than they wish to spend. These are prepared to pay money to anyone who will lend to them.

In this context, a *financial intermediary* is an institution that borrows money from the surplus sector of the economy and lends it to the deficit sector, paying a lower rate of interest to the person with the surplus and charging a higher rate of interest to the person with the deficit. Banks and building societies are the best-known examples. An intermediary's profit margin is the difference between the two interest rates.

But why do the surplus and deficit sectors need the services of a financial intermediary? Why can they not just find each other and cut out the middleman's profit? Actually, there are some cases where this does happen and this is known as *disintermediation*, eg when a company raises funds from the general public by issuing shares.

There are, however, several reasons why both individuals and companies need the services of the intermediaries. The four main reasons relate to the following factors.

- *Geographic location*: firstly, there is the physical problem that individual lenders and borrowers would have to locate each other and would probably be restricted to their own area or circle of contacts. An individual potential borrower in Surrey is unlikely to be aware of a person in Edinburgh with money to lend, but each may have easy access to a branch of a high-street bank.
- *Aggregation*: even if a potential borrower could locate a potential lender, the latter might not have enough money available to satisfy his requirements. The majority of retail deposits are relatively small, averaging under £1,000, while loans are typically larger, with many mortgages being for £50,000 and above. But intermediaries can overcome this size mismatch by aggregating small deposits.
- *Maturity transformation*: even supposing that a borrower could find a lender who had the amount he or she wanted, there is a further problem. The borrower may need the funds for a longer period of time than that for which the lender is prepared to part with them. The

majority of deposits are very short-term (eg instant access accounts), whereas most loans are required for longer periods (personal loans are often for two or three years, while companies often borrow for five or more years and typical mortgages are for 20 or 25 years). Intermediaries are able to overcome this maturity mismatch by offering a wide range of deposit accounts to a wide range of depositors, thus helping to ensure that not all of the depositors' funds are withdrawn at the same time.

- *Risk transformation*: individual depositors are generally reluctant to lend all their savings to another individual or company, principally because of the risk of default or fraud. But intermediaries enable lenders to spread this risk over a wide variety of borrowers so that, if a few fail to repay, the intermediary can absorb the loss.

1.1.2 Risk management

Another way of mitigating risk is offered by insurance, which has been defined as 'a means of shifting the burden of risk by pooling to minimise financial loss'. Individuals effectively get together to contribute to a fund from which the losses of the few who suffer in certain specified circumstances are covered. Without the services of a central organisation – the insurance company – individuals would struggle to find a convenient way of sharing their risks in this manner. The companies therefore provide another form of intermediation.

1.1.3 'Product sales' intermediaries

There is a further type of intermediation, slightly different in nature from those defined above. This is the intermediation that 'oils the wheels' of the financial services industry itself by bringing together the product providers (such as banks and insurance companies) and the potential customers who wish to purchase the providers' products and services. These intermediaries include financial advisers, insurance brokers and mortgage advisers.

1.2 Financial institutions

This section will briefly describe some of the types of financial institution that make up the financial services industry in the UK. Regulatory organisations are not included here because they are described in more detail in Unit 2.

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Prior to the 1980s, there were more clearly defined boundaries between different kinds of financial organisations: some were retail banks, some wholesale banks; others were life assurance companies or general insurance companies, although a few offered both types of insurance and were known as composite insurers; yet others were investment companies. Today, many of the distinctions have become blurred, if they have not disappeared altogether. Increasing numbers of mergers and takeovers have taken place across the boundaries and now even the term *bancassurance*, which was coined to describe banks that owned insurance companies (or vice versa), is inadequate to describe the complex nature of modern financial management groups. For example, one major UK 'bank' offers the following range of services:

- retail banking services;
- mortgage services through a subsidiary that is a former building society;
- credit card services, split into: UK customers; international customers; corporate chargecards; and merchant services;
- wealth management services, for high net worth individuals;
- financial asset management (fund management) for institutional customers;
- investment banking, including financing, risk management and corporate finance advice;
- insurance services, by acting as an independent intermediary in relation to general insurance and as an appointed representative in relation to life assurance, pensions and income protection.

1.2.1 The Bank of England

The Bank of England (often referred to simply as 'the Bank') was founded by a group of wealthy London merchants in 1694 and later granted a Royal Charter by William III. It developed a unique relationship with the Crown and Parliament, which was formalised in 1946 when it was nationalised and became the UK's central bank. A central bank is an organisation that acts as banker to the government, supervises the economy and regulates the supply of money. In the United States, for example, these tasks are the responsibility of the US central bank, which is known as the Federal Reserve. Within the eurozone of the European Union, the European Central Bank (ECB) acts as central bank for those states that have accepted monetary union.

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The Bank of England has a number of important roles within the UK economy. Its main functions are as follows.

- *Issuer of banknotes*: the Bank of England is the central note-issuing authority and is charged with the duty of ensuring that an adequate supply of notes is in circulation.
- *Banker to the government*: the government's own account is held at the Bank of England. The Bank provides finance to cover any deficit by making an automatic loan to the government. If there is a surplus, the Bank may lend it out as part of its general debt management policy.
- *Banker to the banks*: all the major banks have accounts with the Bank of England for depositing or obtaining cash, settling clearing, and other transactions. In this capacity, the Bank can wield considerable influence over the rates of interest in various money markets, by changing the rate of interest it charges to banks that borrow or the rate it gives to banks that deposit.
- *Adviser to the government*: the Bank of England, having built up a specialised knowledge of the UK economy over many years, is able to advise the government and help it to formulate its monetary policy. The Bank's role in this regard has been significantly enhanced since May 1997, with full responsibility for setting interest rates in the UK having been given to the Bank's Monetary Policy Committee (MPC). This committee meets once a month and its mandate in setting the base rate is to ensure that the government's inflation target is met.
- *Foreign exchange market*: the Bank of England manages the UK's official reserves of gold and foreign currencies on behalf of the Treasury.
- *Lender of last resort*: the Bank of England traditionally makes funds available when the banking system is short of liquidity, in order to maintain confidence in the system.

The Bank of England was also formerly responsible for managing new issues of gilt-edged securities. This function has now been transferred to the Debt Management Office within the Treasury, in order to avoid conflicts of interest that might arise from the Bank's responsibility for setting interest rates. Gilt-edged securities, also known as gilts, are loans to the government. There are a wide variety of loans on different terms and for varying periods, including some with no fixed redemption date. These securities are called gilt-edged because the government guarantees their income and redemption amounts.

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In addition to the functions described above, the Bank of England was previously charged with responsibility for the supervision and regulation of those institutions that make up the banking sector in the UK. This responsibility was transferred to the Financial Services Authority with effect from 1 June 1998. The Bank, however, retains its traditional responsibility for maintaining the stability of the financial system as a whole.

1.2.2 Proprietary and mutual organisations

We have already mentioned that the boundaries between different types of financial organisation have become blurred. One distinction that still exists, albeit to a reduced extent, is the split between proprietary and mutual organisations.

Proprietary organisations, which account for the great majority of the large financial institutions, are those that are limited companies. They are owned by their shareholders, who have the right to share in the distribution of the company's profits in the form of dividends and who can contribute to decisions about how the company is run by voting at shareholders' meetings.

By contrast, a *mutual organisation* is one that is not constituted as a company and does not, therefore, have shareholders. The most common types of mutual organisation are building societies and friendly societies, each of which is mutual by definition, and life assurance companies, of which only a small proportion are mutual.

A mutual organisation is, in effect, owned by its members, who can determine how the organisation is managed through general meetings similar to those attended by shareholders of a company. In the case of a building society, the members comprise its depositors and borrowers; for a life company, they are the with-profit policyholders.

Since the Building Societies Act 1986, a building society has been able to *demutualise* – in other words, to convert to a bank (with its status changed to that of a public limited company). Such a change requires the approval of its members, but this approval has in practice generally been readily given, not least because of the windfall of free shares to which the members have been entitled following conversion to a company.

The possibility of a windfall on conversion has led to a spate of *carpetbagging*. This refers to the practice of opening an account at a building society that it is

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believed will soon convert, purely to obtain the subsequent allocation of shares. Societies considering conversion have, in response, sought to protect the interests of their long-term members by placing restrictions on the opening of new accounts.

In recent years, some mutual life assurance companies, including Norwich Union, have also elected to de-mutualise. In May 2006, at a special general meeting, it was decided that Standard Life, the largest mutual life assurer in the UK, would demutualise.

1.2.3 Retail and wholesale

The concepts of retail and wholesale are most obvious in the world of banking. The main distinction between retail and wholesale transactions is one of size, wholesale transactions being generally much larger than retail ones. Because of this, the end-users of retail services are normally individuals and small businesses, whereas wholesale services are provided to large companies, the government and to other financial institutions.

Retail banking is primarily concerned with the more common services provided to personal and corporate customers, such as deposits, loans and payment systems. It is largely the province of high-street banks and building societies that deliver their products through traditional branch networks, call centres, or the Internet.

These institutions are, as described in Section 1.1.1, acting as intermediaries between people who wish to borrow money and people who have money that they are prepared to deposit. The price of borrowing and the reward for investing is, of course, interest.

With the widespread replacement of cheques by credit and debit cards, the traditional suppliers of retail banking are experiencing increasing competition from major stores, such as Tesco and Sainsbury, which are offering their own banking facilities, credit cards and other financial services.

Wholesale banking refers to the process of raising money through the wholesale money markets in which financial institutions and other large companies buy and sell financial assets.

This is the method normally used by finance houses, but the main retail banks are also heavily involved in wholesale banking in order to top up deposits from their branch networks as necessary. For example, if a bank has the opportunity

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to make a substantial profitable loan but does not have adequate deposits, it can raise the money very quickly on the *interbank market.* This is a very large market encompassing over 400 banking institutions, which serves to recycle surplus cash held by banks, either directly between banks or more usually through the services of specialist money brokers.

The rate of interest charged in the interbank market is the *London interbank offered rate (LIBOR)*. It acts as a reference rate for the majority of corporate lending, for which the rate is quoted as 'LIBOR plus a specified margin'. LIBOR rates are fixed daily and vary in maturity from overnight through to one year.

Building societies are also permitted to raise funds on the wholesale markets: up to 50% of their liabilities.

The distinction between 'retail' and 'wholesale' in financial services is much less obvious than it used to be, however, with many institutions operating in both areas. These words are not part of the day-to-day terminology in other financial areas such as life assurance, pensions and unit trusts, but the concepts are present in the background.

- Some organisations are clearly based at the wholesale end of the market, notably product providers such as life assurance companies and unit trust managers.
- Other organisations and individuals, such as insurance brokers and financial advisers, are purely retailers of the products and services offered by the providers.
- Product providers that sell direct to the public or through their own dedicated sales forces are, in effect, operating in both a wholesale and retail capacity.

1.2.4 Money transmission and the clearing process

Money transmission is a term that covers a range of services, including the provision of cash, cheque clearing, direct debits and standing orders, credit and electronic transfers and credit card services. The original source of these services for most customers was through a branch network, with customers visiting their banks to make their transactions and possibly to see their personal or business manager. Although branch networks still exist, many of them are reduced in extent, and numerous other methods of delivery are now also provided, include automatic teller machines (ATMs) in 'remote' locations

such as supermarkets, as well as telephone banking and internet banking for account management and payment of bills.

1.2.4.1 Current accounts

The basis of money transmissions for most people is the current account, which enables money to be paid in or taken out as cash, by cheque or electronically; in the UK current accounts also generally offer an overdraft facility. Originally, current accounts were 'no-frills' accounts on which customers paid monthly or quarterly fees for the service provided by the bank. Fierce competition for customers led most banks to dispense with the fees and sometimes to pay interest on current account balances. More recently some banks have offered current accounts with additional benefits packages including free travel insurance or car breakdown cover.

Traditionally, current accounts were held mainly by middle and higher income groups in the UK, but were much less common amongst lower income groups. To some extent this distinction has been removed by the insistence of many employers on paying wages direct to a bank or building society, but there still remains a significant number of people – estimated at around 1.5 million households in the UK – who do not have a bank account.

This has led to the introduction of a new form of current account, the basic bank account, largely as a result of pressure from the government; it is a simplified current account designed to encourage people who have not previously had an account to open one, and also to be used by people (typically on low income or state benefits) who might not otherwise be able to open a current account.

Basic bank accounts are particularly appropriate for people receiving state benefits or pensions who have been used to receiving their payments in cash. The accounts are able to receive money by a wide variety of methods but the methods of withdrawing money are limited. Cash can be obtained with a card from ATMs and from Post Offices. Payments can be made by direct debit but no chequebooks are issued on these accounts and there is no overdraft facility.

1.2.4.2 Clearing

At the very heart of money transmission services is the clearing process. 'Clearing' in the banking context refers to the process, at the end of each business day, of settling between banks the transfers of money outstanding as

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a result of the use by customers of cheques, direct debits, debit cards, and other means of money transfer. At the end of any particular day, for instance, NatWest will need to pay to Barclays a total sum in relation to cheques written by its customers and banked by Barclays customers – and of course exactly the same will be true in reverse. As a result, a net figure will be due from one of the banks to the other, and this is settled through accounts that the banks hold at the Bank of England.

As a result of the development of more automated methods of fund transfer, such as direct debits and debit cards, cheque volumes are falling and are expected to continue to fall. Around five million cheques a day are issued in the UK, less than half the numbers 15 years ago. More than four times as many card transactions as cheques are used daily, and it is estimated that less than 3% of all non-cash transactions in ten years time will be by cheque.

Not all retail banks are clearing banks. Clearing banks are those that have established their own clearing systems in conjunction with other clearing banks. Other banks and some building societies, which require payment systems to be set up but do not have their own clearing service, have to establish an agency arrangement with one of the clearing banks.

Clearing services in the UK are co-ordinated by the Association for Payment and Clearing Services (APACS), an association of major banks and building societies that acts as the umbrella organisation for the UK payments industry. It manages the major UK payment clearing systems through three operational clearing companies:

- the **Cheque and Credit Clearing Company**, which oversees the clearing of cheques and paper credits on a three-day processing cycle;
- **Voca Ltd**, formerly known as the Bankers' Automated Clearing Services Ltd (BACS), which operates the bulk electronic clearing (eg direct debits); and
- **CHAPS** (the **Clearing House Automated Payment System**), an electronic same-day inter-bank transfer system for high-value wholesale payments.

1.3 The role of government

1.3.1 The influence of the European Union

The UK has been a member of the European Union – as it is now known – since 1973, although it remains outside the eurozone, having chosen not to adopt the euro when the single currency was introduced in 1999.

In spite of the UK retaining – at least for the time being – its own currency and control over its own monetary policy, the financial services industry is hugely influenced by the European Union's policies and laws. Few people realise that large portions of the UK's financial regulatory regime for individuals and for companies are closely determined by European laws. This includes regulation relating to banking, investment, life assurance, general insurance, operating as a financial adviser, compensation for losses, money laundering, data protection and many other areas.

The European Parliament and the Council of Ministers share the power to adopt European laws, often acting on suggestions from the European Commission. These laws can take a number of forms, of which the two most common are *regulations and directives*:

- **regulations** have general application and are binding in their entirety and directly applicable in all member states (unless particular states have specific dispensation);
- **directives** are binding as to the *result to be achieved* upon each member state to which they are addressed. In other words, the objectives of the directive must be achieved within a specified timescale (typically two years) but exactly how they are achieved is left to national authorities in each state.

Many of the regulatory requirements that affect UK financial services organisations can be seen to mirror closely the details found in related European directives.

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1.3.2 Regulation in the UK

Regulation of the financial services industry in the UK is, broadly speaking, a five-tier process.

- *First level*: European legislation that impacts on the UK financial industry. The two main types of European legislation are regulations and directives (see Section 1.3.1).
- *Second level*: the Acts of Parliament that set out what can and cannot be done. Whenever reference is made to Acts of Parliament, it should be borne in mind that the effects of the laws are often achieved through subsidiary legislation – known as statutory instruments – which are made pursuant to the Act. Examples of legislation that directly affect the industry are the Financial Services and Markets Act 2000, the Banking Act 1987 and the Building Societies Act 1997.
- *Third level*: the regulatory bodies that monitor the regulations and issue rules about how the requirements of the legislation are to be met in practice. The main regulatory body is now the Financial Services Authority (FSA), which has taken over the regulatory responsibilities of a number of other bodies, including the Bank of England, which previously regulated the banking sector, and the Building Societies Commission.
- *Fourth level*: the policies and practices of the financial institutions themselves and the internal departments that ensure they operate legally and competently, eg the compliance department of a life assurance company.
- *Fifth level*: the arbitration schemes to which consumers' complaints can be referred. For most cases, this will now be the Financial Ombudsman Service, which has taken over the responsibilities of a number of earlier ombudsman bureaux and arbitration schemes.

The current regulatory regime is described in more detail in Unit 2.

1.3.3 Taxation

Governments use taxation not only for the basic process of raising revenue but also as a means of controlling the money supply. Here we will consider briefly how the manipulation of the taxation regime can have an impact on the financial services marketplace, before we review the main UK taxes. This

section will give an overview of the main UK taxes, together with some detail, but it is not intended to equip its readers to give professional taxation advice.

Changes in taxation affect the market for financial services and products in two main ways:

- ♦ increased general taxation reduces the amount of money available for investment or to fund loan repayments;
- ♦ tightening of the taxation regime for particular products makes them less attractive to investors. An example of this is the government's decision, in 1998, to remove the right of pension fund managers to reclaim tax deducted from dividends received. The effect of this step is that pension funds are now taxed on a proportion of their income, whereas previously they were effectively tax-free. Although this move was clearly made in order to bring in more tax revenue, it seems to be in conflict with the government's acknowledged need to persuade individuals to contribute more toward their own pension provision.

It is worth mentioning that, with many of the more popular investment schemes, such as unit trusts and investment trusts, there are two possible levels at which taxation can occur: the fund managers can be taxed and the investor can be taxed. It is essential to view both aspects when assessing the tax position of an investment.

1.3.3.1 Domicile and residence

Whether or not a person is liable to pay income tax, capital gains tax and inheritance tax will depend on the taxpayer's residence or domicile according to UK law.

Residence mainly affects income tax and capital gains tax. Any person who is present in the UK for at least 183 days in a given tax year is regarded as a UK resident for tax purposes. A person who is not a UK resident in a particular tax year may, however, be defined as ordinarily resident if they normally live in the UK.

A person who is resident or ordinarily resident in the UK should be subject to UK income tax on his or her worldwide earned and unearned income, whether or not such income is brought into the UK. Similarly, capital gains tax is charged on the realisation of gains anywhere in the world. The UK, however, has *double taxation agreements* with many other countries, the purpose of

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which is to ensure that individuals are not taxed twice on the same income or gains.

Domicile is best described as the country that an individual treats as his or her home, even if he or she were to live for a time in another country. Everyone acquires a *domicile of origin* at birth. This is the domicile of their father on the date of their birth (or the domicile of the mother if the parents are not married).

A person can change to a different domicile (known as *domicile of choice*) by going to live in a different country, intending to stay there permanently and showing that intent by generally 'putting down roots' in the new country and severing connections with the former country. There is no specific process for this.

Domicile mainly affects liability to inheritance tax. If a person is domiciled in the UK, inheritance tax is chargeable on assets anywhere in the world, whereas for persons not domiciled in the UK, tax is due only on assets in the UK. Persons who are not UK domiciled but who have lived in the UK for at least 17 of the previous 20 years are, however, deemed to be UK domiciled for inheritance tax purposes.

1.3.3.2 Income tax

Income tax is one of the main sources of government revenue. Liability for income tax is based on income received in a tax year or *fiscal year* that, in the UK, runs from 6 April in one calendar year to 5 April in the next.

Each year, following delivery of the Budget, a Finance Bill is published containing the taxation proposals made in the Budget. When the Bill is approved by Parliament and later becomes law, the new tax measures take effect at dates provided in the legislation.

The new Act (a Bill that has gone through Parliament and has received Royal Assent) becomes a part of the substantial body of legislation that forms the basis of the rules relating to income tax and other taxes.

The main statute is the Income and Corporation Taxes Act 1988 but there are other sources of tax law, both by way of statute and case law.

Tax is due from individuals on their income from employment (including benefits in kind, such as company cars) and also on interest, dividends and other income they receive from investment. All UK residents, including

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children, may be subject to income tax, depending on the type and amount of income they receive.

All residents, both children and adults, who are not income taxpayers, are entitled to make a declaration (on form R85) that they do not pay tax. They are then able to receive interest from certain deposits gross, without deduction of tax at source.

The income of a child that arises from a settlement or arrangement made by the parents, will normally be treated as the parents' income for tax purposes. If treated as the parents' income, a child's unused allowances cannot be set against this income.

Not all of the income that an individual receives is taxable. Examples of types of income that are taxable and of those that are not are given below.

Income assessable to *tax* includes:

- salary/wages from employment, including bonuses and commissions, and taxable benefits in kind;
- pensions and retirement annuities, including state pension benefits;
- profits from a trade or profession;
- inventor's income from a copyright or patent;
- tips;
- interest on bank and building society deposits;
- dividends from companies;
- income from government stocks and local authority stocks;
- income from trusts;
- rents and other income from land and property;
- the value of benefits in kind, such as company cars or medical insurance (if total income, including the value of benefits in kind, exceeds £8,500).

The taxable benefit for company cars is based on the car's carbon dioxide emission rating and is equal to a percentage of the car's list price. The percentage varies between 10% for emissions of up to 120 grams/km and 35% for emissions over 235 grams/km. The list price is the car's UK list price at date of first registration, including taxes and VAT but excluding the road fund licence. It also includes delivery charges and accessories.

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If fuel is also provided by the employer, a further taxable benefit applies.

Income not assessable to *tax* includes:

- redundancy payments and other compensation for loss of office (if total receipts exceed £30,000, then the excess over £30,000 is assessable);
- interest on National Savings Certificates;
- income from ISAs;
- certain covenanted or Gift Aid payments;
- proceeds of a qualifying life assurance policy (in most circumstances);
- casual gambling profits (eg pools, etc);
- lottery prizes;
- wedding presents and certain other presents from an employer that are not given in return for one's services as an employee;
- certain retirement gratuities and redundancy monies paid by an employer (within limits);
- any scholarship or other educational grant that is received if one is a full-time student at school, college, etc;
- certain grants received from an employer solely because an individual has passed an examination or obtained a degree or diploma;
- war widows' pensions;
- certain Social Security benefits;
- housing grants paid by local authorities;
- the capital part of a purchased life annuity (but not the interest portion);
- interest on a tax rebate.

1.3.3.2.1 Allowances

In addition, all UK residents, including children from the day of their birth, have a personal allowance, ie an amount of income that can be received each year before income tax begins to be charged. In the 2008/09 tax year, this allowance is £6,035, rising to £9,030 for people aged 65 and over, and to £9,180 at age 75. Personal allowances cannot be transferred to a spouse or any other person, even where an individual has insufficient income to use the full allowance.

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For persons over the age of 65 whose annual income exceeds a certain figure (£21,800 in 2008/09), the increased personal allowance is reduced, on a scale of £1 reduction for every £2 of income above the threshold. It cannot be reduced below the level of the basic under-65 allowance.

The Blind Person's Allowance (£1,800 in 2008/09) is available to those registered with a local authority as blind. If it cannot be used by the blind person, it can be transferred to the spouse, even if the spouse is not blind.

Prior to April 2000, married couples were entitled to receive an additional allowance, but this has now been withdrawn, except that it continues to be available to couples where at least one spouse was born before 6 April 1935.

In addition to these allowances, taxpayers are permitted to make certain deductions from their gross income before their tax liability is calculated. These include:

- pensions contributions (within specified limits) either to a scheme set up by an employer or to a personal pension or stakeholder pension;
- allowable expenses, such as costs incurred in carrying out one's employment. For self-employed persons, these must be incurred 'wholly and exclusively for the purpose of trade', while for employed persons they must be incurred 'wholly, exclusively and necessarily' while doing the job.

When all the relevant deductions have been made from a person's gross income, what remains is his or her taxable income. This is the amount to which the appropriate tax rate or rates is applied in order to calculate the tax due.

Income tax rates and the bands of income to which they apply are reviewed by the government each year. Any changes are announced in the Budget and included in the subsequent Finance Act.

In the 2008/09 tax year, the tax rate on earned income will be 20% (basic rate) on the first £34,800 of taxable income, and 40% (higher rate) on taxable income above £34,800. For investment income (eg deposit account interest), there will continue to be an initial lower rate band of 10% up to £2,320, with the basic rate (20%) applying between £2,321 and £34,800, and the higher rate (40%) above £34,800. However, if an individual's non-savings taxable income is above £2,320, then the 10% savings rate does not apply. In other words, their deposit account interest is taxed at 20% and 40%.

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For most forms of investment income, tax is normally deducted at source. This applies, for example, to interest on bank and building society deposit accounts and to ordinary shares. In the case of deposit accounts, non-taxpayers can choose to receive their interest without deduction of tax by signing an appropriate declaration. Since many depositors pay basic rate income tax, interest rates are often quoted net, ie after deduction of 20% tax. The true gross rate can be calculated by dividing the net rate by 0.8, so, for example a net rate of 3% is equivalent to a gross rate of 3.75%. Higher rate taxpayers will have to pay a further 20% of the grossed-up interest through their tax returns or tax coding.

A different system applies to share dividends, which are received net of a nominal 10% tax. This is deemed to satisfy the income tax payable by lower rate taxpayers and also basic rate taxpayers, who have no more to pay. In this case, the gross dividend can be calculated by dividing the net dividend by 0.9, so that if a shareholder receives a net dividend of £100, say, the equivalent gross dividend is £111.11. In this case, a higher rate taxpayer has to pay a further 22.5% of the grossed-up dividend, making an unusual total higher rate of 32.5% on share dividends. In the case of share dividends, non-taxpayers are not able to reclaim the 10% tax deducted at source.

The method of collection of income tax from employment depends on the nature of a person's work, as follows.

1.3.3.2.2 Employees

Employees pay income tax under the pay-as-you-earn (PAYE) system, under which the amount of tax due is calculated by their employers using tables supplied by HM Revenue & Customs (HMRC), deducted from their wages or salary and passed on by their employers to HMRC. In order to deduct the right amount of tax, the employer is supplied with a tax code number for each employee: the tax code is related to the amount of 'free' pay for the employee, including allowances, exemptions and adjustments for fringe benefits and for amounts overpaid or underpaid from previous years.

A P60 is issued to each employee by the employer in April each year. This shows, for the previous tax year, total tax deducted, National Insurance Contributions and the final tax code.

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On leaving an employer, an employee should be provided with a form P45 showing:

- name;
- district reference;
- code number;
- week or month of last entries on the employee's deductions working sheet;
- total gross pay to date;
- total tax due to date.

A copy is sent to HMRC. The P45 provides the new employer with all the information they require to complete a new tax deductions working sheet for the employee.

1.3.3.2.3 Self-employed

Self-employed persons (including partners in a business partnership) pay income tax directly to HM Revenue & Customs (HMRC) on the basis of a declaration of net profits calculated from their accounts. Net profits for a self-employed person are broadly the equivalent of the gross income of an employee, ie they are the amount on which income tax is based. They are calculated by taking the total turnover of the business and deducting allowable business expenses and capital allowances.

Under the current self-assessment rules, taxpayers are expected to calculate their own liability and submit their figures to the tax authorities for approval (although tax-payers who submit their returns promptly can ask HMRC to do the calculation for them). Many self-employed people engage an accountant to prepare their accounts for them and to deal with HMRC on their behalf.

1.3.3.2.4 Classification of types of income

Different types of income used to be classified under Schedules A, D, E, and F. These schedules have now been abolished for income tax purposes and replaced by a new regime established under two recent pieces of legislation:

- *Income Tax (Earnings and Pensions) Act 2003*. This covers income that previously fell under Schedule E – income from employment, pensions and taxable social security benefits.

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- *Income Tax (Trading and Other Income) Act 2005*. This covers income that previously fell under the other schedules, in particular:
  - Part 2: Trading income, ie income from self-employment that previously fell under Schedule D Cases I and II;
  - Part 3: Income from property (previously Schedule A);
  - Part 4: Income from savings and investment, including interest, previously under Schedule D Case III, and dividends, previously under Schedule F.

Although the legislative source of the rules has changed, the way in which tax is calculated is unchanged.

1.3.3.2.5 Income taxed at source

Whenever possible, HM Revenue & Customs collects income tax at source, ie from the person who makes the payment, not the recipient. Tax is usually deducted at the basic rate and any further liability at the higher rate will be collected by direct assessment on the taxpayer.

An example of where tax is deducted at source is PAYE (see Section 1.3.3.2.2). Employers deduct tax weekly or monthly (as appropriate) from wages and salaries, which are then paid to the employee net of tax. (This does not take account of other deductions that are also made, eg National Insurance contributions.)

1.3.3.2.6 Tax-paid investment income

Where investment income has been taxed at source, the recipient normally has no further tax to pay, unless as a higher rate taxpayer. Higher rate taxpayers are liable for the difference between the higher rate and the rate of tax deducted at source.

Examples of investments that have income tax deducted at source include:

- interest on fixed-interest loans to companies (eg loan stocks and debentures);
- distributions from unit trusts;

- dividends from UK companies (dividends are not subject to deduction of income tax and are dealt with by the use of tax credits, but the result to the taxpayer is the same);
- the interest from building society and bank deposits;
- the interest element of certain life annuities;
- interest from certain finance company deposits;
- income from trusts and settlements.

In most cases, non-taxpayers can reclaim the tax deducted at source by completing a tax return.

1.3.3.2.7 Taxation of proceeds from a life assurance policy

An investor's premiums paid into a company's life fund are invested in different assets such as property, gilts, shares etc. It is necessary to be aware of how the taxation of the life fund itself impacts on the investor.

In effect, the fund pays sufficient tax to satisfy the basic rate tax liability on income such as dividends, gilt interest or rental income. When the fund sells any of its assets at a profit, it incurs 20% tax on the capital gain.

The net result for the investor is that all benefits coming out of a life fund are deemed to have already borne tax at 20% and for the basic rate taxpayer there is no further liability. There may, however, be a tax liability for a higher rate taxpayer, amounting to 20% of the gain (ie higher rate tax of 40% less the 20% already paid).

This additional tax liability can only arise if the policy is *non-qualifying*. Qualifying policies do not suffer any additional tax. Broadly speaking, in order to be a *qualifying* policy, a policy must meet the following rules.

- Premiums must be payable annually, half-yearly, quarterly or monthly for at least ten years.
  - If premiums cease within ten years, or three-quarters of the original term if less, the policy becomes non-qualifying.
- Premiums in any one year must not exceed twice the premiums in any other year or one-eighth of the total premiums payable.
- The sum payable on death must be at least equal to 75% of the total premiums payable.

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1.3.3.2.8 Taxation of proceeds from a unit trust

The investments within a unit trust will generate income in the form of dividends on shares and gilt interest. Dividends from UK shares are received net of tax; when passed on to unitholders, there is no liability to basic rate tax. There may, however, be a liability for higher rate tax.

Gilt interest and dividends on foreign shares, however, will not have paid UK tax. The unit trust in this instance will pay corporation tax on foreign dividends and basic rate tax on gilt interest. Unit trusts are exempt from capital gains tax (CGT) but unitholders may have a liability if they sell units at a profit.

1.3.3.2.9 Calculation of income tax liability

The calculation of personal liability to income tax is broadly speaking a four-stage process as follows.

1. Ascertain the total income.

2. Make appropriate deductions. For self-employed people, the expenses of running their business are allowable deductions. Employees may also be able to deduct certain expenses if they can show they were incurred 'wholly, exclusively and necessarily' while doing their job. Contributions to a pension scheme can be set against tax and, in the case of occupational schemes, this is done by deducting contributions from gross salary. The tax relief for other pension arrangements such as stakeholder pensions and free-standing AVCs is, however, obtained by deduction from the contributions before they are paid, so these are *not* deducted from income.

3. Deduct personal allowance and other reliefs (eg blind person's allowance).

4. The resultant figure is known as the *taxable income* and the current tax rates are applied to the appropriate bands of income, as described earlier.

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Example 1

A married man aged 30 receives £20,000 (gross) building society interest, and no other income, in the 2008/09 tax year. He has a personal allowance of £6,035.

Gross income	£20,000
Personal allowance	£6,035
Taxable income	£13,965
Income tax due	
£2,320 at 10%	£232
£11,645 @ 20%	£2,329
Total tax due	**£2,561**

Example 2

A single woman aged 40 earns £50,000 (gross) pa in the 2008/09 tax year. She has no other income. She is employed and has a personal allowance of £6,035.

Gross income	£50,000
Personal allowance	£6,035
Taxable income	£43,965
Income tax due	
£34,800 at 20% =	£6,960
£8,565 at 40% =	£3,666
Total tax due	**£10,626**

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If a person's income comes from several different sources, there is an order of priority in which different forms of income are taxed: earned income is taxed first, then interest, and, finally, dividends. This may make a difference because the tax calculation for dividends, for instance, is different from that for interest.

1.3.3.3 National Insurance

National Insurance contributions are a form of taxation in everything but name. They are in effect a tax on earned income and are payable in different ways according to whether the earner is employed or self-employed.

They are classified as follows.

Class 1: these are paid by employees at 11% on earnings between certain levels known as the *primary threshold* (£105 per week in 2008/09) and the *upper earnings limit* (£770 per week in 2008/09), with a reduced level of 1% payable on earnings above the upper limit. They are also paid by employers at 12.8% on employees' earnings above a lower limit called the *secondary threshold* (£105 per week in 2008/09) – but with no upper limit. Reduced contributions apply if employees are contracted out of the state second pension (S2P).

Class 2: these are flat-rate contributions paid by the self-employed if their annual profits exceed a specified lower threshold (£4,825 pa for 2008/09). They are quoted as a weekly amount (£2.30 per week in 2008/09) but are normally paid monthly by direct debit. Many self-employed people also pay Class 4 contributions.

Class 3: these are voluntary contributions that can be paid by people who would not otherwise be entitled to the full basic pension or sickness benefits. This can occur because a person has, for instance, taken a career break or spent some time working overseas. They are flat-rate contributions (£8.10 per week in 2008/09).

Class 4: these are additional contributions payable by self-employed persons on their annual profits between specified minimum and maximum levels, with a reduced rate payable above the upper limit, as for Class 1. They are paid to HMRC in half-yearly instalments along with income tax. The rate for 2008/09 is 8% of profits between £5,435 and £40,040, plus 1% of profits above £40,040.

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1.3.3.4 Capital gains tax

Capital gains tax (CGT) is payable on the net gain made on the disposal of certain physical assets and the realisation of many financial assets, including shares and unit trusts. Most disposals relate to the sale of an asset but the full definition of a *disposal* also includes transferring or giving an asset, or receiving compensation for its loss or destruction.

There are some circumstances under which CGT is not due – in particular, it is not payable when property changes hands as the result of a death (although there may be inheritance tax – see Section 1.3.3.5). There is a 'deemed disposal' of assets on death, when the assets are deemed to be acquired by the personal representatives at their market value at the time of death. This is to establish the cost of acquisition, should it be necessary at some time in the future to calculate capital gains.

Similarly, there are certain assets that are exempt from CGT, including:

- main private residence;
- ordinary private motor vehicles;
- personal belongings, antiques, jewellery and other tangible movable objects (referred to as 'chattels'), provided each object is valued at £6,000 or less;
- gifts of items of national, historic or scientific interest to the nation;
- foreign currency for personal expenditure;
- British government stocks (gilts);
- National Savings Certificates and Save As You Earn schemes;
- premium bonds winnings and lottery winnings;
- gains on qualifying life assurance policies disposed of by the owners;
- individual savings accounts (ISAs).

If an individual makes a loss on disposal of an asset, this can be offset against gains made elsewhere. It must be offset first against gains in the year the loss occurred. Residual losses may then be carried forward to future years. A capital loss cannot, however, be carried back to a previous year.

Tax is payable on net gains made in the tax year, after deducting any allowable capital losses that were made in the same year or carried forward from previous years. Each individual also has an annual CGT allowance (£9,600 in

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2008/09: rather like the personal income tax allowances, this is the level of gains that can be made in the tax year before CGT starts to be payable. This figure also applies to trustees of a mentally disabled person and to personal representatives; half the amount (£4,800 in 2008/09) applies to most other trustees. The annual allowance cannot be carried forward to subsequent years if it is unused in the year to which it applies.

Given that capital losses can be carried forward but the annual exemption cannot, capital losses brought forward are used only to the extent necessary to reduce gains to the level of the annual exemption. Residual losses are then carried forward.

1.3.3.4.1 Calculation of CGT

The calculation of the amount of a taxable gain is governed by a number of rules that make it more complex than merely a simple subtraction of purchase price from sale price. However, the process has been simplified from 6 April 2008 by the removal of 'indexation' and 'taper relief'.

- Costs of purchase can be added to the purchase price and selling costs can be deducted from the sale price.
- The cost of improvements to an asset can be treated as part of its purchase price (but costs of maintenance and repair cannot).
- Capital gains made prior to 31 March 1982 are not taxed so, for an asset acquired before that date, its value on that date must be substituted for the actual purchase price.

When the amount of the gain has been calculated, deduct the annual CGT allowance (if this has not been used against other gains in the same tax year). Then deduct any losses that can be offset against the gain. What remains is the taxable gain.

For individuals, the taxable gain is subject to 18% tax, whatever their rate of income tax. CGT no longer depends on a person's income tax rate.

A lower rate of 10% is applied to the first £1m of cumulative gains arising from the disposal of trading businesses and from certain disposals of shares in trading companies. This is commonly known as 'entrepreneur's relief'. In order to claim this relief, the individual must own at least 5% of the ordinary share capital of the business, which enables them to exercise at least 5% of the voting rights in that company. Most property letting businesses are exempt from this relief.

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Example

Vanessa bought units in a unit trust for £50,000 in May 2003 and sold them for £80,000 in June 2008. At the same time she sold some shares for £10,000 that she had bought for £12,000.

What capital gains tax will she pay?

Gain on unit trust:	£30,000
Deduct annual allowance	£9,600
Deduct loss on shares	£2,000
Taxable gain	£18,400
Tax @ 18%	£3,312

One constant source of complaint about the capital gains tax regime is that CGT is due on the whole gain in the year in which the gain is realised, even where that gain has actually been made over a longer period. This means that only one annual exemption can be set against what may be many years' worth of gain. In the past, some holders of shares and unit trusts sought to minimise the effect of this by selling their holding each year and repurchasing it the following day, thus realising a smaller gain that could be covered by that year's exemption. This was known as *bed and breakfasting*, but the government effectively outlawed the process in the 1998 Budget. Since then, any shares and unit trusts that are sold and repurchased within a 30-day period are treated, for CGT purposes, as if those two related transactions had not taken place.

1.3.3.4.2 Roll-over relief

Business assets are chargeable to CGT. If the assets disposed of are replaced by other business assets, however, roll-over relief may be claimed. This means that, instead of CGT falling due on the original disposal, it is deferred until a final disposal is made.

The replacement asset must be bought within a period of one year before and three years after the sale of the original asset.

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Relief can be claimed up to the lower of either the gain or the amount reinvested.

1.3.3.4.3 Hold-over relief

Similarly, CGT on any gain arising on the gift of certain assets can normally be deferred until the recipient disposes of it.

Gains may be wholly or partly passed on to the recipient in the case of gifts (or sale at under value) of the following broad categories of assets:

- assets used by the donor in his trade or the trade of his family company or group;
- shares in the transferor's personal company or in an unlisted trading company;
- agricultural property that would attract relief from inheritance tax;
- assets on which there is an immediate charge to inheritance tax.

1.3.3.4.4 Payment of CGT

CGT is charged on gains arising from disposals in the period 6 April to 5 April in the following year.

CGT is normally payable on 31 January following the end of the tax year in which the gain is realised. For example, CGT for 2007/08 will normally be payable on 31 January 2009.

Details of chargeable assets disposed of during the tax year must be included in an individual's tax return.

1.3.3.5 Inheritance tax

Inheritance tax, as its name suggests, is levied mainly on the estates of deceased persons. The tax is charged at 40% of the amount by which the value of the estate exceeds the *nil-rate band,* which is up to £312,000 in 2008/09. From 9 October 2007, surviving spouses and civil partners can increase their own nil-rate band by the proportion of unused nil-rate band from the earlier death of their spouse/partner (whether the first death occurred before or after 9 October 2007). So, for example, if on the first death an estate of £200,000 was left entirely to the deceased's son when the nil-rate band was

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£300,000, the unused proportion is 33.33%. If the wife then died when the nil-rate band was £312,000, this could be increased by 33.33% to £416,000. If, on the first death, the estate of £200,000 was left entirely to the deceased's wife (with or without a will), the unused proportion of the husband's nil-rate band is 100%, since transfers between spouses and civil partners on death are exempt from inheritance tax. If the wife then died when the nil-rate band was £312,000, this would have increased by 100% to £624,000.

In order to prevent avoidance of tax by 'death-bed' gifts or transfers, the figure on which tax is based includes not only the amount of the estate on death but also the value of any money or assets that have been given away in the seven years prior to death.

Inheritance tax (IHT) is also payable in certain circumstances when assets are transferred from a person's estate during their lifetime (usually in the form of gifts). Most gifts made during a person's lifetime are *potentially exempt transfers (PETs)* and are not subject to tax at the time of the transfer. If the donor survives for seven years after making the gift, these transactions become fully exempt and no tax is payable. If the donor dies within seven years of making the gift, and the value of the estate (including the value of any gifts made in the preceding seven years) exceeds the nil-rate band, inheritance tax becomes due. The gifts are offset against the nil-rate band first and, if there is any nil-rate band left, this is offset against the remainder of the estate, the balance being subject to tax at 40%. If the value of the gifts alone exceeds the nil-rate band, the portion of the gifts that exceeds the threshold is taxed at 40% along with the remainder of the estate (although the amount of tax on the gifts is scaled down by tapering relief over the final four years of the seven – to 80%, 60%, 40% and 20% of the maximum tax in the fourth, fifth and seventh years respectively.

Some lifetime gifts – notably those to companies, other organisations and certain trusts – are not PETs but *chargeable lifetime transfers,* on which tax at a reduced rate of 20% is immediately due. This 'lifetime' tax is only payable if the value of the chargeable lifetime transfer, when added to the cumulative total of chargeable lifetime transfers over the previous seven years, exceeds the nil-rate band at the time the transfer is made. As with PETs, the full tax is due if the donor dies within seven years (subject to the same tapering relief) and any excess over the 20% already paid then becomes payable.

There are a number of important exemptions from inheritance tax:

- transfers between spouses and between same-sex couples registered under the Civil Partnership Act both during their lifetime and on death;

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- small gifts of up to £250 (cash or value) per recipient in each tax year;
- donations to charity, to political parties and to the nation;
- wedding gifts of up to £1,000 (increased to £5,000 for gifts from parents or £2,500 from grandparents);
- gifts that are made on a regular basis out of income and which do not affect the donor's standard of living;
- up to £3,000 per tax year for gifts not covered by other exemptions. Any part of this £3,000 that is not used in a given tax year can be carried forward for one year, but no further.

1.3.3.6 Value added tax

Value added tax (VAT) is an indirect tax levied on the sale of most goods and the supply of most services in the UK. The current rate is 17.5%.

Some goods and services are exempt from VAT, including certain financial transactions such as loans and insurance. The supply of financial advice is *not* exempt and advisers who charge a fee for their service are subject to VAT in the same way as solicitors or accountants.

The supply of health and education services is exempt and a number of related goods and services are currently *zero-rated*. This is not technically the same as being exempt: zero-rated goods and services are theoretically subject to VAT but the rate of tax applied is currently 0% (although this could change). Zero-rated items include food, books, children's clothes, domestic water supply and medicines. Domestic heating is charged at a reduced rate (currently 5%).

Businesses, including the self-employed, are required to register for VAT if their annual turnover (not profit) is above a certain figure (£67,000 in 2008/09). Firms with turnover below this figure can choose to register for VAT if they wish, but are not obliged to. An advantage of registering is that VAT paid out on business expenses can be reclaimed; two disadvantages are (i) the fact that the firm's goods or services are more expensive to customers (by the amount of the VAT that the firm must charge) and (ii) the additional administration involved in collecting, accounting for and paying VAT.

1.3.3.7 Stamp duty

Stamp duty is a form of tax, payable by the purchaser in respect of certain transactions, notably purchases of securities and of land. It is a tax imposed on the documents that give effect to the transaction (eg conveyances of property or stock transfer forms) and is calculated as a percentage of the purchase price.

It is important to ensure that the documents are stamped within the permitted time period. Failure to do so means, for instance, that the conveyance of the land cannot be registered or that share transfers will not be accepted for registration.

- *Stamp Duty Reserve Tax*: the rate of stamp duty on *securities* is 1.5% of the market value for bearer instruments and 0.5% of market value for shares. From 13 March 2008, transactions that result in a Stamp Duty Reserve Tax charge of £5 or less are exempt. Bearer instruments are financial instruments, such as bonds, on which the name of the owner is not recorded. Possession of the certificate is the only proof of ownership, and title passes by physical delivery to a new owner.
- *Stamp Duty Land Tax:* the rate of stamp duty on *property* depends on the purchase price:
  - there is no stamp duty on purchases of up to £125,000 (or £150,000 in certain designated disadvantaged areas);
  - between £125,001 and £250,000, stamp duty is 1% of the whole purchase price;
  - between £250,001 and £500,000, it is 3% of the whole purchase price;
  - above £500,000, it is 4% of the whole purchase price.

1.3.3.8 Corporation tax

Corporation tax is paid by limited companies on their profits. It is also payable by clubs, societies and associations, by trade associations and housing associations, and by co-operatives. It is not, however, paid by either conventional business partnerships or limited liability partnerships, or by self-employed individuals: these are all subject to income tax.

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Companies are taxed on all their profits arising in a given 'accounting period', which is normally their financial year. The definition of profits includes:

- trading profits (less allowable expenses such as labour and raw materials);
- capital gains;
- income from letting;
- interest on deposits.

Companies resident in the UK pay corporation tax on their worldwide profits, whereas companies resident elsewhere pay only on their profits from their UK-based business.

Corporation tax rates for the tax year 1 April 2008 to 31 March 2009 are outlined in the table below.

	Profits	**Rate**
Small companies rate	£0 to £300,000	21% (rising to 22% in 2009/10)
Marginal rate	£300,001 to £1.5m	A marginal rate to ease the transition between the small companies rate and the main rate
Main rate	Over £1.5m	28%

For companies with profits up to £1.5m, corporation tax is normally due nine months after the end of the relevant accounting period. For those with profits over £1.5m, corporation tax is due in quarterly instalments beginning approximately halfway through the accounting period.

1.3.3.9 Withholding tax

The phrase 'withholding tax' refers to any tax on income that is levied at source before that income is received. So, technically, income tax paid by UK employees is a withholding tax.

However, the phrase is normally understood to apply to tax that is levied, in a particular country, on income received in that country by *non-residents* of that country; this could be earned income or investment income. The aim is to ensure that the income does not leave the country without being taxed. In the

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UK, for example, withholding tax of 20% is levied on the earnings of non-resident entertainers and professional sportsmen/women. The UK has double taxation agreements with over 100 other countries to prevent the same income from being taxed twice.

1.3.4 Economic and monetary policy

At this point, it is useful to consider briefly the long-term objectives that the economic policies of most governments try to achieve. These are known as *macroeconomic objectives* because they concern economic aggregates, ie totals that give us a picture of the economy as a whole, as opposed to *microeconomic objectives* that concern individual firms or consumers.

- *Price stability,* ie a low and controlled rate of inflation. This inflation is popularly defined as a rise in the level of prices. In more formal economic terminology, it can be defined as a situation where the rate of growth of the money supply is greater than the rate of growth of real goods and services; in more common terms, 'too much money chasing too few goods', which, of course, results in prices rising. Price stability does not mean, however, that zero inflation is desirable and there is a body of economic opinion that believes that moderate inflation can stimulate investment, which is good for the economy.

- *Low unemployment,* ie to expand the economy so that there is more demand for labour, land and capital.

- *Balance of payments equilibrium,* ie a situation where expenditure and receipts of foreign currencies are equal. The aim should be to achieve a balance (ie neither a deficit nor a surplus) over the medium term. The UK has, for some years, experienced a deficit on its balance of payments current account with a deficit on manufacturing and on money transfers partly compensated for by a surplus on services and on income from investments. The exchange rate of the country's currency is linked to the balance of payments and most governments aim to keep the price of currency stable at a level that is not so high that exports will be discouraged but not so low as to increase inflation.

- *Satisfactory economic growth,* meaning that the output of the economy is growing in real terms over time and that standards of living are getting higher. The UK economy, like that of other industrialised countries, grew quite fast in the years up to 2000 but this has fallen off with the onset of recession, which has affected the US and European economies. The

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accounts published in the fourth quarter of 2006 showed annual growth of gross domestic product (GDP) in the UK at 3.0%; GDP is a measure of the value of the goods and services produced within the country over a specified period of time.

In practice, it has proven impossible to achieve all of these objectives simultaneously, as the history of the British economy shows. If a government tries to reduce the rate of unemployment by means of expansionary measures such as lower interest rates and lower taxation, demand is boosted and inflation begins to rise. At the same time, people buy more imports and the balance of payments suffers, although the economy will probably grow.

The four objectives given above tend to fall into two pairs: policies to reduce unemployment will also boost growth; measures to reduce inflation will also help to improve the balance of payments. Governments generally have to 'trade off' objectives against each other, eg they want price stability but know that the price of getting rid of inflation altogether would be very high unemployment, so they accept a low inflation rate to avoid pushing the economy into recession.

Economic policy in the UK, from the beginning of the 1960s until fairly recently, was of the 'stop-go' variety, within which governments accelerate and decelerate the economy in turn. This leads to a situation where periods of fast growth, high employment and high inflation are followed by a slowing-down into high unemployment and lower inflation. The current approach in both the UK and Europe aims at growth via price stability.

The current overall long-term objective aimed at by the UK government is to keep inflation steady at a low rate in the hope that price stability will lead to a long period of sustained economic growth. It aims to keep aggregate demand in line with the productive capacity of the economy.

In order to achieve this objective, the government has set an official direct target, which is to keep inflation, as measured by the consumer price index (CPI), at an average annual rate of 2%, with a maximum divergence either side of 1%. This measure is derived in the same way as the harmonised index of consumer prices (HICP) used within the eurozone and has replaced the retail price index (RPI) that was previously used in the UK for this purpose (although the RPI is still used for some other purposes).

To achieve their objectives, the monetary authorities have a range of instruments at their disposal. The main instrument of monetary policy used to keep inflation in check in the UK is the rate of interest, which is manipulated

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by the Bank of England Monetary Policy Committee according to economic circumstances.

There are two major types of policy used by modern governments in their attempts to achieve long-term economic objectives:

- *monetary policy,* which acts on the money supply and on interest rates;
- *fiscal policy,* which acts on public sector spending, revenue and borrowing or saving.

Both types of policy try to influence the level of aggregate demand in the economy and therefore the level of output, unemployment and prices.

1.3.4.1 Monetary policy

Several decades ago, **monetary policy** generally took second place to fiscal policy because governments believed that fiscal policy was the best way of making large adjustments to demand. Monetary policy was felt to be suitable only for fine-tuning. Since 1979, however, monetary policy has become the most important means of controlling the economy.

Monetary policy is based on the ideas of the monetarist school and particularly on those of Professor Milton Friedman of Chicago University. Monetary economists believe that inflation is caused by an increase in the money supply. Broadly speaking, they conclude that, since most of the growth in the money supply is caused by an increase in credit creation by banks, a government that wants to control the growth of the money supply must control the amount of credit creation carried out by banks. A common way to do this is by manipulating interest rates, which in turn influence the demand for credit by customers.

Other methods can be used and have been used in the past. For example, banks can be restricted on the amount they can lend or borrowers can be required to provide a minimum cash deposit when borrowing to make a purchase. None of these is currently in use in the UK, where the favoured method is the manipulation of interest rates. The Monetary Policy Committee (MPC) of the Bank of England decides on the rate of interest at which the Bank of England will lend to banks and other financial institutions (the *repo rate,* commonly known as the *base rate*), and it is this official rate that determines all the other interest rates charged to borrowers and paid to lenders.

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The MPC meets every month to decide whether or not to change interest rates and, if so, in what direction and by how much. It announces its decision immediately after the meeting and publishes the minutes of the meeting two weeks later. The Treasury retains the right to give instructions to the Bank of England regarding its monetary policy in 'extreme economic circumstances'; otherwise the Bank acts independently of the government.

1.3.4.1.1 The impact of interest rate changes

When the MPC decides to change its interest rate, the effect is that all banks and similar deposit-takers have to follow suit and alter the interest rates at which they lend and borrow by something close to the same amount. The mechanism by which this is achieved is not covered in this text.

This means that banks' base rates are inevitably variable rates because they follow the Bank of England's rate, which is adjusted as necessary to put into operation the monetary policy used to control the economy of the UK.

Until fairly recently, most loan interest rates, including mortgage rates, were variable rates. A major disadvantage of variable rates, particularly in relation to a large transaction such as a mortgage, is that it is difficult for the borrower, whose income does not vary in the same way, to budget for likely future expenses. Sudden large rate increases can lead to borrowers being unable to make their mortgage repayments and, in the worst cases, some borrowers may even lose their homes if the lender has to take possession.

With the development of a large and active wholesale money market, it is now possible for lenders to obtain large amounts of money at fixed rates, which they can in turn lend out to their mortgage borrowers and others. Fixed-rate mortgages in the UK still tend to be fixed only for a short initial period, with the rate reverting to the variable rate for the remainder of the term. Longer-term fixed rates are available in many other European countries and it has been suggested that a greater use of long-term fixed rates in the UK would assist in stabilising the sometimes very volatile British housing market. Fixed-rate mortgages do have their own disadvantages, however, not least of which is the danger that a borrower will lose out if the variable rate falls and they are locked into a higher fixed rate. There is normally a penalty for paying off the mortgage within the fixed-rate period, in order to protect the lender. There may also be an arrangement fee, charged by the lender for reserving sufficient funds at the fixed rate.

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1.3.4.2 Fiscal policy

Fiscal policy (which is sometimes called *budgetary policy*) involves influencing the money supply and the overall level of economic activity, including consumption and investment, by manipulating the finances of the public sector (which comprises the central government, local authorities and public corporations).

The public sector has a responsibility to provide certain services that are of national or regional importance, such as education, healthcare and transport. To pay for these services, the government must raise funds from the private sector, ie from individuals and firms, in the form of direct and indirect taxes.

Because the public sector is responsible for taking a large amount of money from the private sector and for making large amounts of expenditure on its behalf, any changes in either side of the account and thus in the balance have a significant effect on the economy as a whole. There are three general outcomes:

- *a balanced budget*: the effect on the economy is neutral because the amount taken away in taxation is put back into public spending;
- *a budget surplus*, where the amount of money taken away is more than that put back: the effect is 'contractionary' in terms of employment and deflationary in terms of the money supply;
- *a budget deficit*, where the amount of money put back is more than that taken out (the difference being the amount borrowed): the overall effect is expansionary in terms of employment and also inflationary in terms of the money supply.

A government that has a deficit must borrow to finance it. The Public Sector Net Cash Requirement (PSNCR) is a cash measure of the public sector's short-term net financing requirement.

The central economic goal of the UK government is to achieve high and sustainable levels of growth and employment. Fiscal policy is directed towards maintaining sound public finances over the medium term, based on strict rules, and towards supporting monetary policy where possible over the economic cycle. The government has specified two key fiscal rules:

- the so-called *golden rule*: over the economic cycle, the government will borrow only to invest and not to fund current spending (there has been some speculation about whether the Chancellor of the Exchequer will have to break this rule to fund current spending);

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- the *sustainable investment rule:* public sector net debt as a proportion of gross domestic product will be held over the economic cycle at a stable and prudent level.

The government outlines its fiscal policy in the annual Budget statement made by the Chancellor of the Exchequer normally in March. The statement includes revenue plans (including taxation of individuals and companies) and the government's planned expenditure. At least three months prior to the Budget, the government publishes a Pre-Budget Report that allows it to consult the public on specific policy initiatives.

Monetary policy acts on the economy as a whole, currently through changes in the general level of interest rates. Although fiscal policy can also have an overall macroeconomic effect on the level of activity in the economy, it has microeconomic effects and can be targeted to particular areas of the economy. For example, tax incentives can be given to manufacturing industries to boost employment in what is a declining sector or government grants can be given to firms that move to relatively underdeveloped geographical areas.

In practice, however, fiscal policy and monetary policy are not applied in isolation but are closely linked, and governments generally use a combination of the two.

1.3.5 Welfare and benefits

In the UK, the government plays a vital role in providing assistance to people in need. Although the 'welfare state' has had its critics in recent years – largely because it is increasingly expensive to run – it still remains the envy of many other nations.

State benefits can affect financial planning in two main ways.

(i) Social Security benefits can affect the need for protection.

The amount of additional cover needed by a client can be quantified as the difference between the level of income or capital required and the level of cover already existing. Existing provision includes not only any private insurances that the client already has, but also any state benefits to which they or their dependants would be entitled.

(ii) Financial circumstances can affect entitlement to benefits.

Certain benefits are 'means-tested' – in other words, the amount of benefit is reduced if the individual's (or sometimes the family's) income or savings exceed specified levels. This might mean, for example, that a financial plan that increased a person's income might be less attractive than it seemed at first sight, if it also had the effect of reducing entitlement to, for instance, Income Support.

There is a wide range of Social Security benefits covering many different circumstances. Many of them, however, are small in amount and can do little more than prevent people from suffering extreme poverty. The whole Social Security benefit structure is very complex and it is not possible to cover every detail here. The main benefits are described in the remainder of this section, together with some information about them that is relevant to the work of financial advisers.

The Department for Work and Pensions (DWP) publishes a wide range of booklets that provide detailed descriptions of the various benefits. These are available from DWP offices, most post offices or by visiting its website at **www.dwp.gov.uk**.

1.3.5.1 Support for people on low incomes

The two main benefits for those on low income, or no income at all, are the Working Tax Credit and Income Support.

1.3.5.1.1 Working Tax Credit

Working Tax Credit is designed to top up the earnings of employed or self-employed people who are on low incomes; this includes those who do not have children. There are extra amounts for:

- working households in which someone has a disability; and
- the costs of qualifying childcare.

People with children can claim Working Tax Credit if they are aged 16 or over and work at least 16 hours a week.

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Those without children can claim Working Tax Credit if:

- they are aged 25 or over and work at least 30 hours a week; or
- they are aged 16 or over and work at least 16 hours a week and have a disability which puts them at a disadvantage in getting a job; or
- they or their partner are aged 50 or over and work at least 16 hours a week and are returning to work after claiming qualifying 'out-of-work' benefits.

1.3.5.1.2 Income Support

Income Support is a tax-free benefit designed to help people aged 16 or over whose income is below a certain level and who are working less than 16 hours per week (or where the partner works for less than 24 hours on average per week). It can be claimed by people with no income at all or can be used to top up other benefits or part-time earnings.

Eligibility for Income Support is not dependent on the claimant having paid National Insurance contributions (NICs). It is, however, means-tested on both income and savings.

Income support can be claimed by people who:

- have income less than an amount specified by the government;
- have capital and savings of less than £16,000. All savings below £6,000 are ignored; if they have savings of between £6,000 and £16,000 then they are assumed to have £1 per week of income for every £250 above £6,000, and this is deducted from their income support payments;
- are working 16 hours a week or less (but people with a disability who work more than 16 hours a week may still be able to get Income Support);
- are not a full-time student;
- are aged 16 or over.

The rules relating to Income Support are complex, and only a brief outline of them can be given here. The range of people who can claim Income Support includes those who are: aged 60 or over; single parents; sick or disabled; looking after a disabled or elderly person; unemployed; only able to work part-time.

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1.3.5.1.2.1 Income Support payments

The exact amount of Income Support payments depends on a number of factors, including: claimant's age; income and savings levels; and whether the claimant has a partner and/or children (and their ages).

Payments are made up of three main parts:

- *personal allowances* (not to be confused with the tax allowances of the same name), which are meant to cover the day-to-day living expenses of the claimant, partner and dependent children;
- *premiums* (nothing to do with life policies), which are additional payments given to people who have extra needs, such as one-parent families or people with disabilities;
- *other additions,* which may include payments for mortgage interest and certain other housing costs.

1.3.5.1.3 Jobseeker's Allowance (JSA)

Jobseeker's Allowance (JSA) is a benefit for people who are unemployed and are actively seeking work.

There are two forms of JSA: *contribution-based* and *income-based*.

Contribution-based JSA depends on having paid sufficient Class 1 National Insurance contributions and is payable for a maximum of six months. It is paid at a fixed rate irrespective of savings or partner's earnings, but no additional benefits are paid for dependants. Contribution-based JSA is paid gross but is taxable.

People who do not qualify for contributions-based JSA may be able to get income-based JSA, which is, to all intents and purposes, Income Support under another name.

Claimants for JSA must satisfy a number of strict requirements, including the following.

- They must be 'capable of actively seeking, and available for' work, normally for at least 40 hours per week.
- They must be out of work or working less than 16 hours per week.
- They must normally be 18 or over but below pensionable age.

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- They must not be in full-time education.
- They must have signed a Jobseeker's Agreement, which sets out the steps they must take to look for work.

Claimants are usually credited with National Insurance contributions (NICs) for every week when they receive JSA.

1.3.5.2 Support for bringing up children

Benefits related to bringing up children fall into two categories: benefits payable during pregnancy and benefits payable as the children are growing up.

1.3.5.2.1 Statutory Maternity Pay (SMP)

Women who become pregnant while they are in employment may be able to get Statutory Maternity Pay (SMP) from their employer. The requirements that a woman must meet in order to receive SMP are as follows.

- She must have worked for the same employer, without a break, for at least 26 weeks including (and ending with) the 15th week before the baby is due – known as the *qualifying week*.
- Her average weekly earnings in the eight weeks up to the qualifying week must not be less than the *lower earnings limit*, the level at which NICs start to be payable.
- She must have paid at least a specified minimum level of Class 1 NICs.

SMP is payable for a maximum of 39 weeks. The earliest it can begin is 11 weeks before the baby is due and the latest is when the baby is born.

There are two rates of SMP: for the first six weeks, the amount paid is equal to 90% of average weekly earnings; after that, the remaining payments are at a flat rate, subject to a maximum of 90% of average weekly earnings.

SMP is taxable and NICs are due on the amount paid.

1.3.5.2.2 Maternity Allowance

Some working mothers who become pregnant are not able to claim SMP. These will include those who are self-employed or who have recently changed jobs. They may be able to claim an alternative benefit called Maternity Allowance.

This is paid by the Department of Work and Pensions (DWP) and not by employers.

Maternity Allowance is paid at a lower rate than SMP but, unlike SMP, it is not subject to tax or NICs on the amount paid.

A standard rate of Maternity Allowance is payable to those whose earnings exceed the lower earnings limit. For those who earn less than the limit but above the minimum threshold for a claim to be made, an amount equal to 90% of average earnings will be paid.

Contrary to popular belief, Maternity Allowance is not a benefit available to all women who become pregnant, whether or not they have been working. There are restrictions on who can claim.

Like SMP, Maternity Allowance is payable for a maximum of 39 weeks. The earliest it can begin is 11 weeks before the baby is due and the latest is when the baby is born.

1.3.5.2.3 Child Benefit

Child Benefit is a tax-free benefit available to parents and others who are responsible for bringing up a child. It is not means-tested and does not depend on having paid NICs. It is not affected by receipt of any other benefits.

Child Benefit is available for each child under age 16. It can continue up to and including age 19 if the child is in full-time education or on an approved training programme. A higher rate is paid in respect of the eldest child and a lower rate in respect of every other child.

1.3.5.2.4 Child Tax Credit

Child Tax Credit is designed mainly to help parents on low incomes but people earning as much as £66,000 per year can be eligible. It brings together the child elements of Income Support, Jobseeker's Allowance and the Disabled Person's Tax Credit and is payable in addition to the entitlement to Child Benefit. The parent does not have to be working to claim Child Tax Credit.

Child Tax Credit is paid directly to the person who is mainly responsible for caring for the child. Payment is made in respect of each child until 1 September following his or her 16th birthday or up to the 20th birthday if the child is:

- in full-time education or on an approved training programme;

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- not claiming Income Support or any tax credit;
- not serving a custodial sentence of four months or more.

1.3.5.3 Support for people who are ill or disabled

There is a wide range of benefits for people who are sick, injured or disabled, or who need constant care.

1.3.5.3.1 Statutory Sick Pay (SSP)

Statutory Sick Pay (SSP) is paid by employers to employees who are off work due to sickness or disability for four days or longer.

SSP is paid for a maximum of 28 weeks in any spell of sickness. Spells of sickness with less than eight weeks between them count as one spell. It is payable to employed people whose average weekly earnings are above the level at which NICs are payable.

Amounts paid as SSP are subject to tax and to NI deductions, just as normal earnings would be.

People who are still sick after 28 weeks may be able to claim short-term Incapacity Benefit.

1.3.5.3.2 Incapacity Benefit

Incapacity Benefit is a benefit for people who are unable to work due to illness or disability. It can be claimed by those who cannot get SSP because they are self-employed or because the SSP payment period has expired.

The right to receive Incapacity Benefit depends on having paid sufficient Class 1 or Class 2 NICs. Those who have not paid sufficient NICs may be able to get Income Support.

Incapacity Benefit has three different levels of benefit, which apply in different circumstances. The lowest rate is not subject to income tax, but the two higher rates are taxable. The rates are:

- *short-term lower rate,* which is payable for up to 28 weeks to people who cannot get SSP;
- *short-term higher rate,* which is payable from 29 weeks to 52 weeks;

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- *long-term rate,* which is the highest rate of Incapacity Benefit and is payable to people who are still sick after a year. People who are terminally ill can get Incapacity Benefit at the highest rate from 28 weeks onwards.

1.3.5.3.3 Attendance Allowance

This is a benefit for people aged 65 or above needing help with personal care as a result of sickness or disability.

Attendance Allowance is not means-tested and it does not depend on having paid NICs.

There are two levels of benefit: a lower rate for people who need help with personal care by day or by night and a higher rate for those who need help both by day and by night.

1.3.5.3.4 Disability Living Allowance (DLA)

This is a tax-free benefit for people who need help with personal care and/or need help getting around. It can only be received by people whose disability claim began before age 65 but, once granted, it can continue beyond age 65.

To be eligible for Disability Living Allowance (DLA), a person must have needed help for a qualifying period of three months and must be expected to need help for a further six months. The qualifying period is waived for people who are not expected to live for six months.

There are two components to DLA and claimants may receive either or both:

- *care component*: this component is for people who need help in carrying out daily tasks such as washing, dressing, using the toilet or cooking a meal;
- *mobility component*: this component applies if a person has difficulty in walking or cannot walk at all.

1.3.5.3.5 Carer's Allowance

The government recognises that support is also needed for carers, ie people who give up a large part of their time – and possibly their jobs – in order to look after someone who is seriously ill or severely disabled. Carer's Allowance

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(CA) is a benefit for people who are caring for a severely disabled person; they do not have to be a relative of the patient in order to qualify.

The right to receive CA does not depend on having paid NICs. The benefit is a flat rate, with possible additions for a partner or children. It is taxable and must be declared on tax returns.

The following criteria must be met.

- The carer must:
  - be aged between 16 and 65;
  - spend at least 35 hours per week as a carer;
  - be earning no more than a certain amount each week;
  - not be in full-time education (defined as 21 hours or more a week of supervised study).
- The person being cared for must:
  - be receiving Disability Living Allowance or Attendance Allowance or Constant Attendance Allowance;
  - not be in hospital or in residential care.

1.3.5.4 Support for people in hospital or receiving residential/nursing care

When people are in hospital, some of the needs normally met by benefits or pensions are instead met by the National Health Service. In the past, therefore, some benefits have been reduced or suspended while a claimant is in hospital. In the 2005 budget, however, it was announced that these reductions will no longer be made.

For those in a residential care or nursing home provided by a local council, who cannot afford the minimum charges, Income Support may be available. For those in residential or nursing care in a private establishment, Income Support may be available provided that savings do not exceed £16,000. Income Support amounts are worked out by adding together the fees for the home and any meals that have to be paid for separately, subject to a maximum benefit amount depending on the type of care received.

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1.3.5.5 Support for people in retirement

The government first introduced pension provision in 1908 but state pensions first appeared in something like their current form after the Second World War when the National Insurance Act 1946 provided for pensions to be payable to employed people on retirement at age 65 (men) or 60 (women). These ages still apply today but, by 2020, state retirement age will have been equalised at 65 for both men and women.

This flat-rate pension, now known as the *basic state pension,* was not related to an employee's earnings. It was later extended to include self-employed people and others who have made sufficient National Insurance contributions – which basically means that they have contributed for 90% of their working life (with benefits being scaled down pro rata for lower contribution levels).

The National Insurance Act 1959 first introduced a second tier of state pensions, in which benefits were earnings-related. This was known as the *graduated pension scheme* and operated from 1961 until it was replaced by the *state earnings-related pension scheme (SERPS),* which came into operation in 1978. SERPS was itself replaced in 2002 by the *State Second Pension (S2P).*

1.3.5.5.1 Basic state pension

The basic state pension always was – and still is today – designed to provide little more than a subsistence-level standard of living. It is set at approximately 25% of the national average earnings level. In 2008/09, the single person's basic state pension is £90.70 per week and the married couple's rate is £145.05 per week.

The pension is administered on a pay-as-you-go basis, with current National Insurance contributions from the working population being immediately paid out as current pensions to those entitled to receive them. It is readily apparent that, with the number of pensioners increasing and the numbers in employment decreasing, there is little scope for increasing state pensions by anything more than the rate of inflation. The government proposes to increase the basic state pension in line with the average earnings index rather than a cost of living index, but this will not be implemented until 2012.

1.3.5.5.2 Additional state pension

The objective of the state earnings-related pension scheme (SERPS) was originally to boost pension provision from 25% of national average earnings (ie

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the basic pension) to a level around 50%. Like the basic pension, it is funded on a pay-as-you-go basis, a system that is coming under increasing cost pressures. This has resulted in a scaling-down of prospective benefits, which are determined by a complex formula, and there is every likelihood of further reductions in the future.

SERPS was replaced by the State Second Pension (S2P) in 2002. Although initially offered on an earnings-related basis, it will change to a full flat-rate basis at a later date (as yet unspecified). New contributions are to S2P but previously purchased SERPS benefits are retained.

Unlike the basic pension, S2P is available only to employed persons who are paying Class 1 National Insurance contributions. Self-employed people cannot currently be members of S2P. Employed people are in fact obliged to be in S2P unless they contract out or are contracted out by their employer on the basis of membership of the employer's pension scheme. Contracting out is permitted only if the employer, or the individual, provides acceptable alternative pension provision. If an employer runs a contracted-out pension scheme, the employer and employees who are members pay a reduced level of National Insurance contributions. If an employee contracts out individually, full contributions are still paid but a rebate is given in the form of a transfer to his or her alternative pension arrangement.

1.3.5.5.3 Pension Credit

The Pension Credit is a benefit designed to ensure that all people of retirement age have a total income of a specified minimum amount. In 2008/09, Pension Credit guarantees a minimum income of £124.05 per week to a single person and £189.35 to a couple. Like the state pensions, this amount is expected to increase each year to take account of inflation.

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Test your knowledge and understanding with these questions

Take a break before using these questions to assess your learning across Section 1. Review the text if necessary.

Answers can be found at the end of this unit.

1. What are the four main elements of financial intermediation, as practised by banks and building societies?

2. How does a mutual organisation differ from a proprietary organisation?

3. Who issues UK banknotes?

   (a) The Bank of England.

   (b) The Treasury.

   (c) The Royal Mint.

4. What is the effect of European Union directives on UK law?

5. Karen was born in the United States while her mother, Laura (born and bred in England), was working there on a two-year assignment. Her father was American but he and Laura never married, and she returned to England with Karen. What is Karen's domicile?

6. Which of the following is not subject to income tax?

   (a) Income from a trust.

   (b) A waiter's tips.

   (c) Educational scholarships.

7. What classes of National Insurance contributions are paid by self-employed persons?

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8. What rate of inheritance tax is payable immediately on chargeable lifetime transfers?

9. How much Stamp Duty Land Tax is payable by a woman who sells her house for £395,000?

10. It is possible to influence a nation's level of economic activity by manipulating the amount of tax revenue and the amount of spending by the government, local authorities and public bodies. What is the name for this kind of economic policy?

11. What is the maximum term for which Maternity Allowance can be paid?

12. What is the minimum period per week that must be spent as a carer before Carer's Allowance can be claimed?

    (a) 25 hours.

    (b) 30 hours.

    (c) 35 hours.

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Answers

1. Geographic location; aggregation; maturity transformation; risk transformation.

2. Mutual organisations have no shareholders but are owned by their members.

3. (a) The Bank of England.

4. The objectives of the directive must be implemented in each state, including the UK, within a specified timescale, typically two years. The choice of exactly how they are implemented is left to national authorities in each state.

5. Her domicile of origin is the domicile of her mother at the date of her birth (not the domicile of the father, since they were not married). This is probably UK domicile, although we don't know for certain without knowing more about Laura's parents.

6. (c) Educational scholarships.

7. Subject to specified minimum profits levels, Class 2 and Class 4.

8. 20%.

9. None. Stamp Duty Land Tax (like all forms of stamp duty) is paid by the purchaser.

10. Fiscal policy.

11. 39 weeks.

12. (c) 35 hours.

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