2011/12

PENSIONS UPDATE

The new retirement landscape

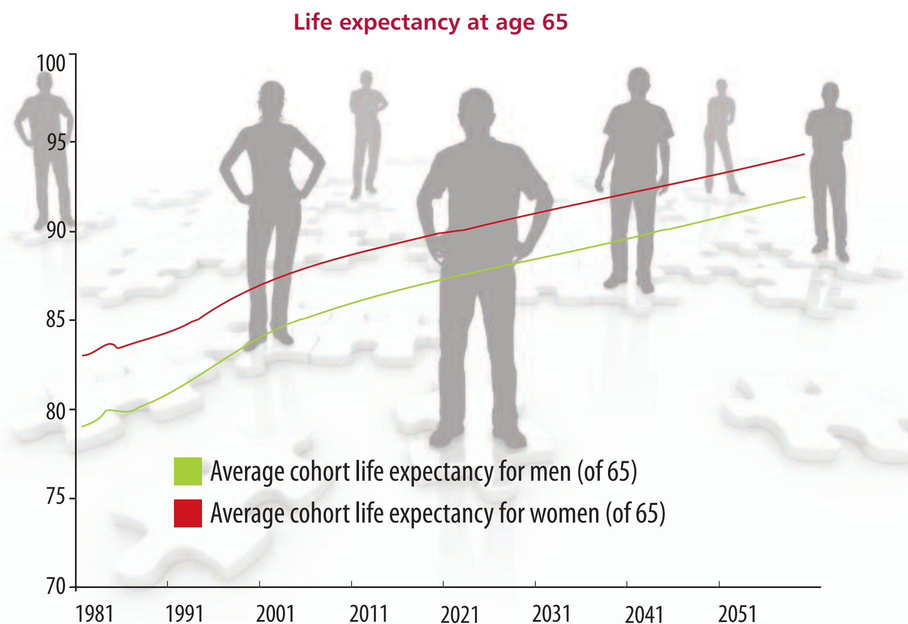
Living longer, costing more

The world of pensions has changed apace in recent years. Reforms have been announced to the tax regime, state pensions and private sector provision. Some changes have already happened, while others are yet to be finalised.

While the Government has been legislating with zeal, private sector employers have been restructuring their pension arrangements.

The rising cost of pension provision has been the driving force for both the state and the private sector reforms. Not only are more people living to pension age, but once they become pensioners they are living longer, as the graph shows.

Life expectancy at age 65



©iStockphoto.com/studiovision

The problem of cost has been worsened by low long-term interest rates and difficult investment conditions since the turn of the century. For example, to provide a level (non-increasing) pension annuity of £1,000 a year now costs about £16,500 for a 65 year-old man and £17,500 for a 65 year-old woman. Adding inflation-proofing increases both these figure by around 65%.

Among the state's solutions have been raising the state pension age and increasing national insurance contributions (NICs). Private sector employers have attempted to reduce costs by closing their final salary (defined benefit) pension schemes to new members and, increasingly often, to existing members as well.

In this special report we look at how past, present and future changes to pensions will affect you. If any of the reforms covered strike a chord, take expert advice before revising your retirement plans. The ever more complex world of pensions contains many financial traps for the enthusiastic amateur.

Rowhurst Wood,
Oxshott Road,
Oxshott,
Surrey KT22 0EN

T. 01372 844344
F. 01372 844530
E. paula.smith@blacktowerfm.com
www.blacktowerfm.com

Blacktower Group with offices in the UK, Gibraltar, Portugal, Spain & France.
Blacktower Financial Management Ltd is Authorised and Regulated in the UK by the Financial Services Authority

This newsletter is for general information only and is not intended to be advice to any specific person. You are recommended to seek competent professional advice before taking or refraining from taking any action on the basis of the contents of this publication. The FSA does not regulate tax advice, so it is outside the investment protection rules of the Financial Services and Markets Act and the Financial Services Compensation Scheme. The newsletter represents our understanding of law and HM Revenue & Customs practice as at January 2012.

State pensions – doing more with less

Changes to state pensions have come thick and fast, although their full impact will take time to emerge. A good example is state pension age (SPA) reform.

The rising SPA There was a time when SPA was a certainty, but today it is a moving target. Since April 2010 women's SPA has been rising. The original plan was for it to reach age 65 – matching men's SPA – by April 2020, with the SPA for both sexes to rise to 66 between 2024 and 2026. However, the Government has introduced an accelerated schedule in the Pensions Act 2011. In the 2011 Autumn Statement, the Chancellor announced that SPA would rise to 67 between April 2026 and April 2028, with further increases 'based on demographic evidence'. This will almost certainly mean a SPA of 68 arriving earlier than provided for in current legislation. A SPA of 70 is now quite possible before 2050. If you are unsure as to when your new SPA is, please contact us.

©iStockphoto.com/Bartosz Hadyniak

Basic state pension (BSP)
The number of 'qualifying years' you need to receive a BSP was reduced to 30 from 6 April 2010. A number of other changes have also been made, most of which are marginally for the better. In the June 2010 Budget, the Government announced that the BSP will be increased each year by whichever is the highest of average earnings growth, the growth in prices measured by the consumer prices index (CPI), or 2.5%.

This change helps preserve the BSP's future buying power, but its level remains low: the 2012/13 BSP will be £107.45 a week for a single person and £171.85 a week for a married couple.

State second pension (S2P) S2P was introduced in 2002 as a refinement of the state earnings-related pension scheme (SERPS). It provides a second-tier earnings-related pension for employees who are not contracted out via private pension arrangements. In 2009, the upper limit of earnings that count towards the S2P was frozen at £770 a week. In theory, the long-term effect of the freeze is that S2P will become a second-tier flat-rate pension, worth about £70 a week in today's terms. In practice S2P in its current form is likely to disappear before that long term arrives, as explained below.

Since April 2011, increases to S2P and SERPS in payment have been linked to the CPI, rather than the retail prices index (RPI) as they were in the past. Over the last 20 years the CPI has averaged about 0.7% a year less than the RPI, so by and large the change is seen as an effective cut.

From April 2012, the option to contract out of S2P will be limited to defined benefit pension schemes. You will (re)join S2P automatically in 2012/13 if you currently contract out via a personal pension or money purchase occupational scheme.

Future changes The Green Paper published in April 2011 suggested two routes to introduce a flat-rate state pension, worth about £140 a week. The option considered more likely to be followed would see the creation of a single state pension replacing BSP, S2P/SERPS and a large part of Pension Credit. It would also end defined benefit contracting out, simplifying the NICs system. Both options pose some awkward transitional issues, made worse by the Government's stated intention that 'any options for reform must be cost neutral in each and every year'.

> ***planning point*** Knowing what your total state pension benefits are (under current rules) and when you will receive them is an important retirement planning starting point. The Department for Work and Pensions can normally provide a projection of your state pension benefits, but their systems have not yet been updated for the most recently announced changes to the SPA. For more information, go to: www.direct.gov.uk/ adn click on the StatePension area to find your forecast.

Occupational pensions

Employer-sponsored occupational pension schemes used to be the bedrock of private pension provision. They continue to have a significant number of members – 27.2 million in 2010, according to the Office for National Statistics.

However, the number of 'active members' (i.e. employees accruing benefits) in private sector final-salary schemes is now only 2.1 million, down from 5.1 million in 1995. In the public sector, the move until now has been in the opposite direction, although this is set to change as employment falls and a new career average scheme is introduced.

Private sector employers started closing their final-salary schemes to new members in the last century, and the pattern has since extended to ending future accrual for existing employees. If you are still accruing benefits in a final-salary scheme, consider yourself lucky: you are unlikely to accrue them if you change job, unless you move to a public sector employer.

The Government has made one change to final-salary schemes which, in contrast to many previous reforms, may slow the closure process. As with state pensions, the Government has altered the statutory basis of inflation increases from RPI to CPI. The switch applies to both deferred pensions (for early leavers) and pensions in payment.

The impact of this in practice depends upon the rules of your scheme. All public sector schemes, along with some private sector schemes, switched to the CPI basis from April 2011. However, many private sector schemes have continued to use only the RPI in making adjustments, because their trust documentation refers to that index.

> ***planning point*** If you have a preserved pension – often incorrectly labelled a 'frozen pension' – from a former employer's final-salary occupational scheme, it makes sense to look at your transfer options now. Falling long-term interest rates could mean your transfer value has risen in recent years.

Tax relief and contributions

Pension contributions have always been favourably treated from a tax viewpoint. In very broad terms:

- Personal contributions attract full income tax relief, with a minimum of 20% relief, even for non-taxpayers.
- Employer contributions are fully relievable against profits.
- Employer contributions are exempt from NICs.

The tax relief given to pension contributions cost the Treasury £20.7 billion in 2009/10, so it is not surprising that new constraints on relief have appeared in the past couple of years. These have been targeted at high earners and designed, at least in part, to prevent the 50% top income tax rate being circumvented.

In April 2009 the previous Government introduced the special annual allowance (SAA) regime, eventually aimed at those with income of £130,000 or more. From 6 April 2011 the SAA rules were replaced with a drastically lowered annual allowance, the limit on your total tax-relievable pension contributions from all sources. The allowance was cut from £255,000 each tax year to £50,000, although there is now scope to carry forward unused allowance from the previous three years, including periods before 2011/12. Any contribution above the available allowance will, in effect, receive no tax relief. In extreme circumstances this could mean you will personally have to pay full income tax on some of your employer's pension contributions.

Even if the much reduced annual allowance does not prevent you from building up a large fund, there is another obstacle, due in April 2012. The lifetime allowance – effectively the maximum value of pension benefits before special tax charges can apply – will fall from £1.8 million to £1.5 million. You will be able to apply for fixed protection, which leaves your lifetime allowance at £1.8 million, but only if no more is paid into your pension after 5 April 2012.

> ***planning point*** The introduction of the £50,000 annual allowance, the new carry forward relief and the £300,000 cut in the lifetime allowance from April 2012 mean it is more important than ever to undertake a thorough review of your pension contribution plans. 2011/12 might be the last year in which it makes sense for you – and your employer – to put money into a pension.

Increased choice: drawing benefits

There was a time when buying an annuity was the only retirement option available outside of final salary schemes once you had taken your tax-free cash. Now there is a wide choice and one which is likely to expand as new legislation is introduced.

Annuities An annuity may well be the right way to draw all or some of your benefits, particularly if you have few other sources of income when you retire. A key factor is that the payments from an annuity will last for the rest of your life – however long that may be.

If you decide on an annuity, you should never just accept what your pension provider offers. In recent times the annuity market has become more sophisticated, with your home post code, previous employment, smoking habits and long-term health conditions (e.g. diabetes) all having a potential impact on your income level. You will need independent advice to discover all that is available to you: newspaper league tables are too simplistic.

Income withdrawals It has been possible to make regular withdrawals from your pension fund since 1995 (rather than buying an annuity). This involves investment risk – your withdrawals and pension fund could both fall in value – so in general it is only suitable if you have other sources of retirement income.

The income withdrawal option – now officially called 'drawdown' – gives you considerable flexibility in choosing your income and, on the whole, offers superior death benefits to annuities. The entirety of the remaining fund can be paid as a lump sum death benefit, subject to a newly increased flat 55% tax charge, but normally no inheritance tax. Income withdrawals used to stop at age 75, but following changes announced in 2010 and new measures introduced from April 2011, it is now possible to continue withdrawals for as long as you wish.

Another April 2011 reform was the introduction of flexible drawdown, which allows income to be drawn free of any limits.

©iStockphoto.com/Linda Alstead

However, you must have at least £20,000 of guaranteed lifetime income to apply for flexible drawdown

'Third Way' annuities This term applies to retirement income products which fit neither the annuity nor the income withdrawal categories. They often incorporate some income guarantee – though lower than an annuity would provide – with limited flexibility and similar death benefits to income withdrawal. This has been the main area of innovation and recent legislative changes may see it develop further.

> ***planning point*** The decisions you take at retirement are crucial and can be irreversible. You should start reviewing your options at least six months before you want your retirement income to start.

NEST and auto-enrolment

October 2012 is scheduled to see the official start of the five-year phased introduction of auto-enrolment, which is supported by the introduction of the National Employment Savings Trust (NEST).

Auto-enrolment is the latest Government effort to encourage private pension provision among the UK's unpensioned masses. An employer's automatic enrolment date will depend on the number of staff, with the largest companies first.

Unlike the failed stakeholder pensions regime, auto-enrolment involves quasi-compulsory contributions. NEST is being developed as a pension suitable for lower-earners who do not currently have easy access to pensions. Under the current plans:

- NEST will be run as a single occupational scheme, independent of the government.
- All taxpaying employees – in broad terms those with income over £8,105 in 2012/13 – aged between 22 and the SPA will be automatically enrolled into a pension scheme, which could be NEST or another pension scheme that allows auto-enrolment.
- Employees may opt out, but they will be automatically re-enrolled every three years or on changing employer.
- Employers will generally have to pay a contribution equivalent to at least 3% of an eligible employee's qualifying earnings, probably in a band between £5,564 and £39,853 (in 2012/13 terms), if the employee has earnings of more than £8,105. The required contribution will be lower during a phasing-in period, which is expected to last until about 2018.
- Employees will ultimately have to pay a contribution to bring the total up to 8% of band earnings. Allowing for income tax relief, this implies a 4% net employee contribution, if the employer pays the 3% minimum.

If you are an employer, auto-enrolment will apply to you, even if you have only one taxpaying employee.

> ***planning point*** The long phasing-in period for auto-enrolment is not an excuse for ignoring the issue. If you are an employer, you need to start thinking now about the impact of auto-enrolment – and those 3% contributions – on your business.

Non-pension retirement options

Although the emphasis in this report has been on pension arrangements, it would be wrong to consider pensions as the only retirement planning option. Indeed, you may not be able to make contributions to any pension arrangements because to do so would attract tax penalties.

There is a variety of other routes to building a retirement fund, including:

- **Individual savings accounts (ISAs)** From a tax viewpoint ISAs are the mirror image of pensions: there is no tax relief on the initial investment, but no income tax when benefits are taken.
- **Collective funds** Open-ended investment companies (OEICs) and unit trusts form the basis of many of the investments underlying pension arrangements. Outside of the shelter of a pension they will normally be subject to more tax, but the treatment of capital gains remains attractive, particularly if you are a higher or additional rate taxpayer.
- **Maximum investment plans (MIPs)** These are specialist investment-based life assurance policies. While the underlying funds incur tax – generally at no more than basic rate on income and gains – there is no further tax if plans are run through to maturity.
- **Venture capital trusts (VCTs)** VCTs offer 30% tax relief on the initial investment (clawed back if the fund is sold within the first five years). Dividends are free of income tax (although tax credits cannot be reclaimed) and no capital gains tax is payable. These tax benefits come at a price: VCTs have to invest at least 70% of their funds in small unlisted companies, which means high risks. These will therefore not be suitable for everyone, and advice should be sought before investing.

For most people pension arrangements remain the most tax-efficient way of investing for retirement. If, for whatever reason, you choose not to use pensions, you should seek professional advice before selecting the alternative(s).

The importance of reviews

One theme running through this report is the many changes being made to all areas of pension provision. The pension framework has rarely been stable, but last year's change of government has prompted a quickening in the pace of reform, the full effects of which are now beginning to emerge.

In this environment, it is more important than ever to keep your retirement plans under regular review. This is a task which you need to undertake with your professional adviser we have in-depth knowledge of developments in the pension market and are herer to help.

Important notes

1. The value of tax reliefs depends on your individual circumstances. Tax laws can change. The Financial Services Authority does not regulate tax advice.
2. The value of your investment and the income from it can go down as well as up and you may not get back the full amount you invested. Past performance is not a reliable indicator of future performance.
3. Shares and share-related funds should be regarded as long-term investments and should fit in with your overall attitude to risk and your financial circumstances.

Paper produced using FSC mixed sources from well managed forests and other controlled sources, at a mill that is certified to the EMAS environmental management standard.