

2010/11

PENSIONS UPDATE

The new retirement landscape



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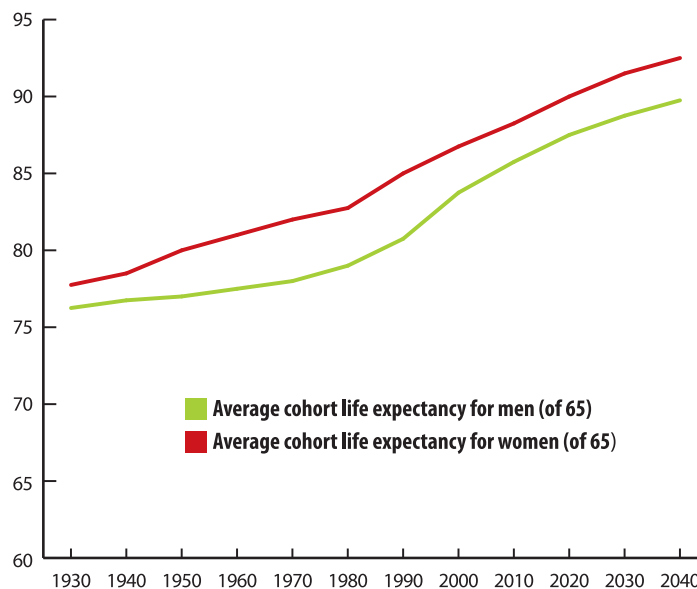
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Living longer, costing more

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 state and 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:



The problem of cost has been worsened by low long-term interest rates and difficult investment conditions over the last ten years. For example, to provide a level (non-increasing) pension annuity of £1,000 a year now costs about £16,000 for a 65 year-old man and £17,000 for a 65 year-old woman. Adding inflation-proofing increases both these figure by around 60%.

Among the state's solutions have been raising the state pension age and increasing national insurance contributions. 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.

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State pensions

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

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 announced an accelerated schedule (see below). There has also been a clear message that the timetable for future SPA rises will be reviewed, and it is very likely that the dates for increases beyond 66 will be brought forward.

| Date of birth | SPA for men | SPA for women |
|------------------------------|-------------|---------------|
| Before 6 April 1950 | 65 | 60 |
| 6 April 1950–5 April 1951 | 65 | 60–61 |
| 6 April 1951–5 April 1952 | 65 | 61–62 |
| 6 April 1952–5 April 1953 | 65 | 62–63 |
| 6 April–5 August 1953 | 65 | 63–64 |
| 6 August–5 December 1953 | 65 | 64–65 |
| SPA for men and women | | |
| 6 December 1953–5 April 1954 | 65–66 | |
| 6 April 1954–5 April 1968 | 66 | |
| 6 April 1968–5 April 1969 | 66–67 | |
| 6 April 1969–5 April 1977 | 67 | |
| 6 April 1977–5 April 1978 | 67–68 | |
| 6 April 1978– | 68 | |

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 from April 2011 the BSP will be increased each year by whichever is the highest of:

- The growth in average earnings; or
- The growth in prices, measured by the retail prices index (RPI) for 2011 and the consumer prices index (CPI) from 2012 on; or
- 2.5%.

This change helps preserve the BSP's future buying power, but the starting point is low: the 2010/11 BSP is £97.65 a week for a single person and £156.15 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 it may be different, as explained below.

From April 2011, increases to S2P and SERPS in payment will be linked to the CPI, rather than the RPI as they were in the past. Over the last 20 years the CPI has averaged about 0.5% 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. At present, you will (re)join S2P automatically if you contract out via a personal pension or money purchase occupational scheme.

Possible future changes Several press reports in October 2010 suggested that the Government was considering the introduction of a £140 a week pension. The logic behind this was that a single pension, based on UK residence, would replace BSP, S2P/SERPS and Pension Credit. No ministerial confirmation was forthcoming, but the idea echoes a long-term proposal in the Liberal Democrats' 2010 manifesto.

> planning point Knowing what your state pension benefits are and when you will receive them is an important retirement planning starting point. The Department for Work and Pensions can provide a projection of your state pension benefits. For more information, go to: www.thepensionsservice.gov.uk/resourcecentre/br19/home.asp

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 – 27.7 million in 2009 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 2.3 million, down from 5.1 million in 1995. In the public sector, the move has been in the opposite direction, although this is set to change as employment falls.

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 announced one change to final-salary schemes which, in contrast to many previous reforms, may slow the closure process. As with state pensions, the Government is altering the

statutory basis of inflation increases from the retail prices index (RPI) to the consumer prices index (CPI). The switch will apply to both deferred pensions (for early leavers) and pensions in payment.

The impact of this in practice will depend upon the rules of your scheme. All public sector schemes, along with some private sector schemes, will switch to the CPI basis from April 2011. However, many private sector schemes will be forced to use the greater of RPI and CPI in making adjustments because their trust documentation refers to the RPI.

> 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. If the current proposals on contracting out of S2P come to fruition, your transfer options will be much reduced from April 2012.

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 relievably against profits.
- Employer contributions are exempt from national insurance contributions.

The tax relief given to pension contributions cost the Treasury £19 billion in 2008/09, 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. The rules are complex:

2010/11: special annual allowance You may be affected by the special annual allowance if your relevant income (broadly your total income less certain deductions) is £130,000 or more for the current tax year, or it was in either of the two previous tax years. The effect is that the maximum fully tax relievably contributions payable by

you and/or your employer in 2010/11 could be as little as £20,000 (the special annual allowance). Any contribution above the limit only qualifies for basic rate tax relief. Special rules apply if you are a member of a final salary scheme or have a history of making regular contributions.

2011/12: annual allowance A new set of restrictions to pension contribution tax relief will apply from 6 April 2011, when the special annual allowance regime ends. In simple terms, the replacement will limit your total tax-relievably pension contributions from all sources to £50,000 per tax year. There will be scope for carrying forward unused allowance from the previous three years, including periods before 2011/12. Any contribution above the ceiling will, in effect, receive no tax relief.

Even if these hurdles do 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.

> planning point The replacement of the special annual allowance by the £50,000 annual allowance means it is more important than ever to review your pension contribution options before the end of the tax year.

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 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, currently subject to a flat 35% tax charge. This flat rate tax charge is set to rise to 55% from April 2011, but at the same time any potential liability to inheritance tax will disappear. Income withdrawals used to stop at age 75, but following changes announced in 2010 and new measures to be introduced from April 2011 it will be possible to continue withdrawals for as long as you wish.



New rules will also see existing alternatively secured pensions converted to income withdrawal from April 2011, removing the spectre of the 82% tax charge residual funds can be subject to at present.

'Third Way' annuities This term labels 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 four-year phased introduction of auto-enrolment and also 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.

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 £7,475 in 2011/12 – aged between 22 and state pension age 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 earnings in a band between £5,715 and £38,185 (in 2010/11 terms). The required contribution will be lower during a phasing-in period lasting until 2017.

- Employees will 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 the recent change of government has prompted a quickening in the pace of reform, the full effects of which will take time 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, because they will have in-depth knowledge of developments in the pension market.

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.