

PENSIONS HAVE GOT A LOT SIMPLER

Pensions are among the most tax-efficient and effective ways to save for retirement, but working out how much to save and deciding which type of pension is best often feels like a complicated business.

The good news is from 6th April 2006, so-called “A-Day”, life got simpler for retirement savers as the government brought in a new simplified set of rules, effectively shelving the eight previous tax frameworks for pensions, which made life very complicated for everyone.

The changeover means it ought to be easier than ever to begin calculating how much you ought to be saving for your future.

The new rules have given savers far greater freedom in how and when pension benefits are taken.

Pensions have long offered attractive tax breaks. This means for higher rate taxpayers a contribution of £100 only costs £60, for basic rate taxpayers the same contribution costs £80, as the Government providing the £40 and £20 respectively in tax relief.

Certain elements of pension simplification create even more generous tax breaks for some savers. For example, those paying into any pension arrangements which under the old rules did not allow the plan holder to take any tax-free cash from the fund when they come to take benefits from the pension, now find that they can now take 25 per cent of the value of the fund as a tax-free lump sum.

Simplification ought to have taken some of the mystery out of pensions, but with the new flexibility has come new dilemmas for would-be savers, as well as those already building up their retirement nest eggs.

For this reason, many would do well to discuss with an independent financial adviser what steps they might need to as a consequence of the changes made on the 6th April 2006, and also how their pension needs might be met because of the rule changes.

In this guide we break down what has changed and what pension simplification means for your retirement saving options.

A-DAY: THE MAIN CHANGES

One of the main changes is that, regardless of whatever type of pension you may have, you and your employer will be able to pay up to one annual allowance for that tax year. This amount is up to 100 per cent of your earnings and for the tax year 2009/10 this allowance is capped at £245,000, with the limit set at £3,600 for low or non-earners paying into personal and stakeholder pensions.

The single allowance rule does away with the sometimes baffling calculations individuals faced under the old tax regulations in order to work out what they could pay into their pensions.

It is hoped the end of complicated calculations removes one of the barriers preventing people from saving more.

A further move designed to encourage us to save more is the greater ease with which people can save into a number of different pensions at the same time under the new rules, compared with the old.

That said, within the contribution limits, the onus is still on individuals to work out how much they ought to be saving and how much they can realistically afford to put aside.

It remains as important as ever to strike the right balance between saving enough for retirement while not leaving yourself either short of cash month to month or for rainy days and predictable large costs such as school or university fees, even your children's weddings.

An independent financial adviser (IFA) will be able to steer you through this sometimes tricky path and find the right balance, by looking at your retirement savings and your entire financial circumstances together.

They will also help you work out how much you can afford to save and what you should be aiming to put aside over the years and importantly, how much you will need to save now to maintain the quality of life you want in retirement.

Research in 2005 by the Association of British Insurers indicated that more than 60 per cent of people are not confident that they will have enough money to live comfortably during their retirement. With the right advice, you need not be among this number.

Anyone planning for their retirement, however distant, ought to recognise that the Government is looking to discourage people from retiring early. The earliest age pensions can be taken increases from 50 to 55 in 2010. Anyone planning to retire early in the next five or so years will almost certainly need to speak to an adviser to work out how the change will impact upon their plans.

MORE TAX-FREE CASH

Under the old pensions rules some plans, such as certain occupational schemes, allow savers to take more than 25 per cent of their fund as tax-free cash when the time comes to take the benefits. However, others, such as top-up pensions Additional Voluntary Contribution schemes, do not allow any tax-free cash to be taken.

Legislation now allows all pensions policyholders to take **25 per cent tax-free cash** on the benefits built up after 6th April 2006, regardless of the kind of scheme it is. (The amount those in occupational schemes will be able to take as tax-free cash may depend on whether the trustees have changed the scheme rules, meaning individuals may need to contact their scheme's trustees to establish what the situation is).

Permitting all pension policyholders to take 25 per cent tax-free cash levels the playing field between different pensions. This means it will be a good idea to re-consider which pension arrangements are the most attractive to you with the help of an expert IFA.

LIMITS ON THE SIZE OF YOUR PENSION

There is a limit on the amount of money built up within your pension. In the tax year 2009/2010 this amount is £1.75 million, with the threshold expected to rise over the years to allow for the impact of inflation (see Table 2 at the end of this document).

This is also the maximum amount that can be paid out as a tax free lump sum to your beneficiaries in the event of your death, giving much greater flexibility to provide death benefits via pensions after A-Day.

Introducing one lifetime limit for pension fund size effectively bins the sometimes complicated calculations savers could be forced to work through under the old pension rules.

A further innovation under the new rules is that the value above the lifetime limit will be

subject to a new tax charge known as the **lifetime allowance charge**, or recovery tax, which will be charged at up to 55 per cent.

This measure is aimed at curtailing the amount of tax relief individuals can get from pensions.

A pension fund of more than £1.75 million might sound like the preserve of the very rich, but it is likely that more individuals than they realise will be in danger of breaching the lifetime limit and potentially facing a 55 per cent tax hit.

This is because the lifetime limit relates to your entire pensions savings, including any private pensions, occupational pensions, free-standing additional voluntary contributions, so many people who think they are well below the lifetime limit might have more than they realise when they take into account the full picture.

This means it will be essential for certain pension savers likely to be on the brink of the lifetime limit to keep on top of the size of their total pension fund as they build it up.

Dealing with the paperwork and calculations may seem daunting, but a pensions IFA will be able to project realistically the value of retirement savings into the future.

PROTECTING YOUR PENSION

Pension savers who have already bust the £1.75 million pension threshold or are concerned about doing so are strongly recommended to seek professional advice on how to shield their savings from the lifetime allowance charge or, alternatively, how to maximise tax breaks under the current rules.

It is possible to register your pension fund value built up before 6th April 2006 to protect it against the lifetime allowance charge and pension savers have until April 2009 to do this, although the sooner you understand your options the better you can plan accordingly.

The first thing you may want to consider if you are at or near the lifetime limit is getting a valuation of your entire pension savings, before considering putting certain protective measures in place, which will harbour the fund from the lifetime allowance charge.

An IFA will be well-placed to guide you through this rather complicated area, but generally speaking, there are two levels of protection available.

So-called '**primary protection**' is available where the value of pension funds was over the £1.5 million lifetime limit on A-Day,

Going for primary protection will shield the value of your pension you have already built up and can potentially allow it to continue to grow in line with the increases in the lifetime limit without triggering the lifetime allowance tax charge.

'**Enhanced protection**' is available to any fund regardless of its size. Roughly speaking, this shelters not just the current value of pension savings, but also the full value of future investment returns, without incurring a tax penalty. However this option is only available where no further contributions have been made or will be made in the future or, if you are in a final salary scheme, that your benefits have not and will not in the future increase above certain limits and no new benefits are built up in respect of your employment after A-Day.

Most experts agree ensuring you have a plan in place to protect your savings because of the impacts of pension simplification is an area where you will almost certainly need advice

and struggle to do-it-yourself. Anyone with a pension pot worth more than £1million will almost certainly need guidance.

NEW OPTIONS ON PENSION BENEFITS

If you have a money purchase pension (where the value of the pension fund at retirement is based on the amount paid in and how much this has grown by, such as personal and stakeholder pensions), then when you come to retire your income is normally secured by the purchase of an annuity (compared to final salary schemes where income can be paid out direct from the pension fund).

An annuity is effectively a promise to pay you an income for the rest of your life and is sometimes described as 'insurance against living too long', because with an annuity, your income from it lasts as long as you do.

Individuals are compelled to take benefits from their pensions by age 75 as they are now, however, the new pensions rules offer far greater flexibility over how benefits are taken.

For example, since 6th April 2006 we have seen the introduction of new types of annuities.

'**Limited period annuities**' permit you to buy annuities in smaller chunks, each spanning a five year term, while the rest of your fund can be left invested. This will give individuals more choice on when to buy annuities and also allows them to maintain more control over their pension fund.

New '**value-protected annuities**' respond to one of the key criticisms of annuity, that is, if you die very shortly after buying an annuity, your family loses out on your life's savings because the money is absorbed by the collective fund of an insurance company's annuity policyholders.

The most common criticism of traditional annuities was that if you die 'early' your money is effectively absorbed and re-distributed among those who live longer.

Roughly speaking, under value protected annuities, if on death the money used to purchase the annuity has not been used up by an individual and they are under age 75, the balance can be paid to the policyholder's estate after a tax charge of 35 per cent has been deducted.

However, it is essential to stress this potential benefit will be reflected in the rates for protected value annuities, which could be notably lower than on regular annuities.

'**Unsecured pensions**' are also available. This is similar to income drawdown under the old rules, where investors do not buy an annuity, but can take the tax-free cash sum and leave the remaining fund invested and income is taken from the invested fund and returns. Unsecured pensions can be used up to age 75 and policyholders can take up to a maximum amount up to 120 per cent of the annual income payable from a single life, level annuity. There is no minimum amount.

Under the new pension rules, once you reach age 75 you will still normally have to purchase an annuity, if you have not already done so, although there is now an option called an '**alternatively secured pension**' (ASP) which may be attractive to some people, particularly those who have a principled religious objection to annuitisation.

OTHER PLANNING OPPORTUNITIES

Pension simplification has created many other planning opportunities, whether you are self-

employed or within a company pension scheme, and whether you have any existing pension provision or not.

If you have old pension schemes which are no longer active, perhaps because you left the employer who provided the scheme, or if you have a pension contract you are not familiar with, you could be well advised to seek out advice about the possibility of **transferring or** at least **optimising the benefits** of these pension funds.

Also if you have a small pension fund or funds when you reach your planned retirement date, it is now possible you will be able to take out the whole sum as a lump sum, rather than buy an annuity. The limit for 2009/10 is £17,500, which equates to 1 per cent of the lifetime allowance.

Those shopping around for independent financial advice should be sure to enquire about the qualifications an adviser has, but should also bear in mind it might be as helpful and meaningful to enquire about an adviser's experience in certain areas.

We can help you decide what action to take. Questions include:

- How much should I save into my pension?
- How much can I save without incurring a tax penalty?
- What are extra options under the new rules and are they appropriate to me?
- What are my options when I come to take benefits from my pension?
- Now the tax treatment for all types of pensions is similar, how can I tell which are best suited to my needs?
- Is there any action I ought to consider because of the rule changes to safeguard my benefits and make the most of tax breaks under the old regulations?

TABLE 1

Proposed contribution annual allowances

2008/2009 £235,000

2009/2010 £245,000

2010/2011 £255,000

TABLE 2

Proposed lifetime allowance limits

2008/2009 £1.65m

2009/2010 £1.75m

2010/2011 £1.80m

For further information on the subject contained in this guide, please contact us