

Pension Simplification.

Consumer Guide to 'A' Day

What is happening with Pensions

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 gets easier for retirement savers as the government brings in a new simplified set of rules, effectively shelving the eight previous tax frameworks for pensions.

The changeover means it ought to be easier than ever before to begin calculating how much you ought to be saving for your future. In addition, pension simplification brings with it extra retirement funding choices, including residential property and even fine art. The new rules will also give savers far greater freedom in how and when pension benefits can be 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 £78, as the Government provides the £40 and £22 respectively in tax relief.

Certain elements of pension simplification will create even more generous tax breaks for some savers. For example, those paying into any pension arrangements that 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 will find after A-Day that they can now take 25 per cent of the value of the fund as a tax-free lump sum.

Simplification ought to take some of the mystery out of pensions, but with the new flexibility 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 take in the run-up to 6th April and how their pension needs are to be achieved after the rules change.

In this brochure, we break down what is changing and what pension simplification will mean for your retirement saving options. It is important to note that there remain some areas of detail surrounding the regulations awaiting finalising, but the framework and implications of the changes are now set and the sooner you start thinking about how this affects you and what action may be required the better.

The main changes

One of the main changes occurring on 6th April 2006 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 2006/07 this allowance is capped at £215,000, 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 baffling calculations individuals faced under the old tax regulations in order to work out what they could pay into their pensions. 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.

Your independent financial adviser (IFA) will be able to steer you through this 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 at which pension benefits are accessible following A Day will increase 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 affect 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.

From 6th April 2006, legislation will allow all pensions policyholders to take 25 per cent tax-free cash on the benefits built up after A-Day, 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 the trustees changing the scheme rules, meaning individuals may need to contact their scheme's trustees to establish how the situation might change).

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 after 5th April with the help of an expert. Ahead of this deadline, those with plans, which under the old rules allowed them to take more than 25 per cent, ought to consider protecting these benefits.

Alternatively, those approaching retirement and who have pensions where there was no tax-free cash benefit under the old pensions regime might need to consider whether they should delay taking benefits until after 5th April 2006. Your IFA will be able to guide you through either protecting or delaying your pension benefits where appropriate.

Limits on the size of your pension fund

After A Day, there will be a new limit on the amount of money built up within your pension. In the tax year 2006/07, this amount is £1.5million, with the threshold expected to rise over the years to allow for the impact of inflation. 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 complicated calculations savers were 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.

The aim of this measure is to curtail the amount of tax relief individuals can get from pensions. A pension fund of more than £1.5 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 at the 5th April 2006 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 pension IFA will be able to project realistically the value of retirement savings into the future.

Protecting your pension

In the run-up to April 6th 2006, some pension savers who have already bust the £1.5 million pension threshold should 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 this date 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.

Your IFA is placed to guide you through this rather complicated area, but there are two levels of protection available. So-called 'primary protection' is available to pension funds 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 recovery 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. This is if no further contributions are made or, if you are in a final salary scheme that your benefits do not 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 in preparation for 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 pension investment choices.

A-Day will also see the Government relax the rules over what kind of investment individuals can hold within their pension. This change potentially opens the door for individuals to hold residential properties, such as holiday homes, buy-to-let properties, and even in some limited circumstances private homes within their pension.

The rules also allow for more flexibility of invests within pension fund, including fine art, classic cars and gold. The relaxation of pension investment rules offers some exciting opportunities, but these will only be appropriate for a relatively small proportion of investors and will demand specialist tax, pension and legal advice, all of which come at a price.

One of the most initially appealing parts of pension simplification is the potential to buy bricks and mortar with your pension while attracting significant income tax relief. This change means higher-rate taxpayers, for example, have the chance of buying a £100,000 buy-to-let property at a net cost of just £60,000 after tax relief if the property is held within their pension fund.

In addition, if you do not have enough money to buy a property, your pension can take out a mortgage up to a maximum of up to 50 per cent of the pension scheme assets. Rental income from the property and capital gains are tax-free, while the usual costs of buying property is deducted from income, including stamp duty, legal fees, surveys as well as the costs of employing lettings agents to find tenants to manage the property on your behalf.

It is also important to recognise investing in residential or overseas property, while appearing relatively straightforward and appealingly tax efficient, will involve taking specialist legal, tax and financial advice because the transactions involved are ultimately complicated.

Also, there is no such thing as a free lunch under the new rules: there will be additional tax charges where a pension scheme member or someone related or connected to them, enjoys the benefits of an investment such as a holiday or residential home and does not pay commercial rents for that use.

The costs and complexity may well put off many would-be pension property savers.

New options on pension benefits

An annuity is effectively a promise to pay you an income for the rest of your life. After 5th April 2006 individuals will still be 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, A-Day will allow the introduction of new types of annuity.

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

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

A Day will also introduce 'Unsecured pensions. 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 taken income 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 have to purchase an annuity, if you have not already done so, or go for a new option called an 'alternatively secured pension' (ASP).

Although less attractive to pension members who need to rely on their pensions for income, for some, ASPs can work as a 'family' pension plan. Your spouse, children and yourself can all be members with the facility to pass pension assets to your children's pension, for example. Under ASPs, your spouse or dependants can either buy an annuity or continue to draw an income from your fund after you die. If there is no spouse or no dependants, the pension value or assets can be paid to another member of the pension scheme or a charity.

Using an ASP arrangement looks particularly enticing if you have invested in a residential property within your pension, but again, the Inland Revenue will prevent these sorts of set-ups becoming a way of avoiding inheritance tax, so caution and professional advice are recommended.

Other planning opportunities

Within the pension simplification rules there are many other planning opportunities for individuals, 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. This needs to be done before A-Day.

if you have a small pension fund or funds, it is possible that after A-Day you will be able to take out the whole sum as a lump sum, rather than buy an annuity. The limit for 2006/07 is £15,000, which equates to 1 per cent of the lifetime allowance.