

Article placed in Retirement Planner

Fit for purpose

November 2011

On 22 June 2011 the Office for National Statistics released a number of interesting “Pension Trends” statistics. A few topical snippets jumped out:

- Participation in pension schemes in the private sector is falling. In 2010, 39 per cent of male employees and 28 per cent of female employees belonged to an employer-sponsored pension scheme in the private sector. This compared with 52 per cent and 37 per cent respectively in 1997.
- While membership of employer-sponsored pension schemes fell in the private sector between 1997 and 2010, in the public sector it was unchanged for men, at 87 per cent, and it rose for women, from 75 per cent to 82 per cent.
- The General Lifestyle Survey shows that 38 per cent of full-time self-employed men in Great Britain belonged to a pension scheme in 2009, down from 64 per cent in 1998/99.

The release that accompanied the statistics made the obvious point that falling pension scheme membership implies less private pension saving which will lead to reduced retirement income in future, unless you see other saving increases.

I have made the point many times in articles that I have always been of the opinion that getting the foundations right for pension investors requires:

1. a clear incentive system that everyone understands.
2. simple rules around what you can contribute.
3. flexibility on what you can do with your money when it is in the pension arrangement.
4. flexibility & fairness on how you get your money back out in retirement or on death.

It is early days and I would be the first to admit that the system of tax relief is not perfect. However, in the first few months of the new regime from 6 April 2011 we experienced a significant increase in new contributions to our SIPPs. This must be viewed as a positive step forward and I believe the drivers for this increase are straightforward:

- Replacing the complex anti-forestalling rules with a simple, single annual allowance of £50,000.
- The increase in higher rate and additional rate (50%) tax payers. The thresholds for higher rate tax and additional rate tax were not increased in 2011/12 meaning a much larger group of people are now subject to higher and additional rate tax. The Government’s own statistics indicate that the number of higher rate taxpayers will increase by 20% this year, with additional rate taxpayers increasing by 12%. That is a lot more people who could benefit from tax relief on pension contributions.
- The re-introduction of carry forward, potentially allowing pension savers and their employers to pay contributions of up to £200,000 in any given tax year and receive tax relief.

Contribution and tax planning opportunities have historically been embraced by advisers and driven up new pension contributions. Whilst it is not perfect, we now have an incentive system that investors understand. With this basic ingredient, there is every reason to believe that the pickup in new contributions will continue.

Whilst things are looking up on the contribution front, I still have the nagging doubt that point 4 above will remain a stumbling block for some. We now have a uniform tax charge of 55% applied to lump sum death benefits paid from pensions in drawdown, and to benefits that have not been put into drawdown where an individual is over the age of 75.

We argued long and hard that the old ASP tax rules represented cliff edge tax policy and were simply unfair. With no tax on death on pre crystallised funds and a 55% charge on crystallised funds a cliff edge remains. If fairness is a key driver for change it would have been equitable for the Government coffers and simple to introduce a simple charge to tax on all residual pension funds irrespective of the age and vested status of the client of say 20% – 25%. Over time we will find out

if this will be a stumbling block for savers, my gut feeling continues to suggest that for some it will be.

Despite this the 2011 tax year end was a record period for benefit claims at A J Bell as clients and their advisers looked to make the most of changes to the pension regulations. We also had the introduction of flexible drawdown, a new concept that has been at the centre of a great deal of discussion and debate. Some providers have suggested that the complexity of the new proposals and challenges with system development have led to problems and delays.

Are the rules that complicated? The Finance Bill has now received Royal Assent and there was tinkering around the edges with the rules but nothing that would prevent a provider from offering flexible drawdown from 6 April. The majority of the rules remain the same. Individuals with a secure income which meets a Minimum Income Requirement (MIR) will be allowed to withdraw funds from their pension schemes in excess of the limits imposed by drawdown pension.

It could be said that the introduction of flexible drawdown and the drafting of the regulations was all a little rushed. However, putting this aside the early evidence suggests that there is clear demand from advisers and their clients. Just after 6 April we completed a piece of research with 250 advisers who used Sippcentre. The responses showed that 98% believed that they will use flexible drawdown as part of their clients' retirement and income planning. Importantly, more than 82% indicated that the main use would be phasing the fund to flexible drawdown as part of a structured plan to match income requirements and minimise the possible taxation implications. I don't believe that flexible drawdown will be a mainstream solution but there is demand for it.

Some providers seem concerned about the obvious risk of many clients running down their pension funds but looking at the responses to the survey this seems unfounded. Over the years I have worked for providers that apply charges on a percentage basis. I know from experience that the actuarial people responsible for pricing and profitability will have a negative view of a product that allows you to run down the fund. This will have affected the appetite of many providers to offer this option. If there is demand in the market the answer would seem to be to re-visit your pricing philosophy.

Rather than seeing a significant acceleration in withdrawal for all using flexible drawdown, I believe it will instead develop into a useful option for savers to reduce the marginal rate of tax on income drawn from pensions, whilst at the same time reducing the effect of the 55% tax charge on lump sum death benefits.

Looking at a case study the background to the theory should become clear.

Mr Smith has a secure annuity income of exactly £20,000 and so satisfies the Minimum Income Requirement which qualifies him for flexible drawdown.

His SIPP fund is worth £600,000 which he has yet to vest or crystallise.

Mr Smith could immediately take a lump sum of £150,000 and withdraw the whole fund. The obvious downside to this is that he will pay 50% tax on the majority of the income and will place the funds into a non tax relieved environment and one where the funds are potentially subject to IHT on his death.

Alternatively he could take a lump sum of £150,000 and withdraw an income of £22,475 a year from the SIPP, making full use of the 20% tax band. This is likely to be significantly more tax efficient than the first option as ongoing income is drawn at 20% and the bulk of the funds remain free from IHT. The problem with this option is that, on death, the residual fund paid as a lump sum death benefit will be subject to a tax charge of 55%.

He could consider using flexible drawdown and then crystallising a small part the core fund each year and immediately withdrawing the entire fund balance on the small amount that has been vested. For example, Mr Smith could crystallise £29,966 in 2011/12 receiving £7,491 as a tax free lump sum and withdrawing the crystallised fund as a single taxable pension payment.

Taking the tax free lump sum and taxable pension together, he will only be paying 15% tax on the combined income. On top of this, because the fund that is left in the pension each year remains fully uncrystallised, any lump sum death benefits paid from the fund will not be subject to a tax charge.

The rumour mill is gathering pace and there have been suggestions that the pension regime, incentives, benefits and all could be subject to review once again. The Coalition Government must have learned from the mistakes of the previous Government. The day after the 2009 Budget we took calls from many investors looking to cancel their pension applications. As it turned out, the majority were not affected by the new rules but a common theme was that many had become frustrated by the constant tinkering and lacked trust in future Government policy. There is always a risk of unintended consequences when you look at change. Change is not always a bad thing but, as has happened in the past, it is when it leads to disenfranchised investors.

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Please note this document is intended for trade and national press individuals.

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