

Simple it won't be!

Pensions legislation in the past has consisted of adding yet another layer of rules onto those already in place. This has led to a proliferation of different regimes, with different rules applying depending when the scheme was set up, and whether service started before 1987, between 1987 and 1989 or after 1989. And different sets of rules apply for employer pensions - which have been largely benefit limited - and employee and self-employed pensions - which have been largely contribution limited.

Simplification will remove this distinction. It will also allow more money to be paid into pensions. Instead of individual calculations based on salary, age and length of service with an employer we will have a simple lifetime limit of £1.5m and an annual limit of £215,000, both of which will increase annually for at least the first 4 years. Contributions can exceed these limits, but there will be no tax relief for higher contributions and employees will be subject to a benefit in kind tax charge on employer contributions exceeding the annual limit.

There will be no maximum pensions, only a maximum tax-free cash sum (or 'pension commencement lump sum') of 25% of the fund at retirement (or 'benefit crystallisation event'). The 25% cash will now apply to all pension schemes, including Free Standing AVCs and Protected Rights which currently allow no cash. That is, of course, providing that the schemes change their rules to permit this, which is far from certain for many closed schemes or insured policies where the provider is closed for new business. It will also apply to those who have transferred funds and are presently subject to a cash certificate which gives them less than 25% cash, although there is some doubt over the position of nil tax free cash certificates in divorce cases.

The minimum retirement age will rise to 55 from 2010, but there is to be no corresponding rise in the maximum age of 75.

There will be new rules on permitted investments, including the much-publicised residential property option, and new limits on borrowing by pension schemes. The opportunity to use pension funds to buy residential property has been described by some pensions experts as the greatest mis-buying opportunity since Norman Fowler decided that opting out of employer paid pension schemes was a good idea!

Drawdown, also known as Pension Fund Withdrawals, will gain a new, less clear, name 'Unsecured Income', and will be subject to new limits. In particular the new minimum income will be zero. After age 75 there will be the option to secure income through an annuity or to opt for 'Alternatively Secured Pension' (ASP), which actually means unsecured income but with a lower maximum than 'Unsecured Income'!

Who will it affect?

The Lifetime Limit of £1.5m will obviously affect those with particularly large pension funds. It will also affect high earning members of final salary pension schemes,

particularly those expecting to receive pensions in excess of about £60,000 p.a. or those with other substantial pensions.

For those with existing pensions or in existing drawdown plans these could be valued at a significantly higher figure than their original investment. The multiple of 25 times the maximum withdrawal could mean that 'relevant existing pensions' could count as more than double their actual fund value.

Transitional protection will be available, but this is far from simple.

Simplification will also affect members of Small Self Administered Schemes and Self Invested Personal Pensions who were planning to use their funds to buy commercial property, as the borrowing limits will fall dramatically.

People taking pension fund withdrawals will need to decide whether to change their income levels, particularly if they are drawing minimum income and do not need it. They will also need to reassess their investment holdings if their income levels change, or if they expect to remain in drawdown after 75.

Those approaching age 75 will have new decisions to make about whether or not to buy an annuity, and if not how to structure their investments within their plan. This will need to be considered well before their 75th birthday.

People who had hoped to retire before 55 will be unable to do so unless they will be 50 before April 2010, or they had some form of arrangement to do so already in place when Simplification was announced in December 2003.

Those people planning to use their pension funds to provide a lump sum only, which is permissible under current rules, will require to use 75% of the fund to buy a taxable pension after April 2006, although they too may be able to benefit from transitional protection.

What should clients do now before Simplification comes in?

If they are earning more than £60,000 p.a. or they already have pension funds valued at more than £1m, they should be talking to a pensions professional as soon as possible to discuss transitional protection. They should be prepared to pay a fee of up to £2,000 plus vat to get the right advice.

Unfortunately, even if clients are already certain that they will need to apply for transitional protection, they cannot do so until April 2006. This is because they will be required to quote the exact value of the funds they wish to protect as at 5 April 2006 for them to be protected. Clients will have until April 2009 to apply for protection, which is probably just as well given the number of people who will be seeking values in April 2006!

If a client wants to ensure that the remaining pension fund can be paid in cash to the estate on death after age 75, they should transfer to London & Colonial's Open Annuity now, as the Revenue has stated that this will not be possible after April 2006.

If clients are looking to use their pension fund to buy commercial property they need to do so urgently, unless they will not require any borrowing to complete the purchase. At present a pension fund with £100,000 can borrow up to £300,000; after April the same fund will only be able to borrow £50,000 – not much use if the property value is £250,000!

For those planning to retire before age 55, but who will be aged between 50 and 54 on 5 April 2010, they need to make sure to commence taking benefits before April 2010 – even if drawing zero income!

What should clients *not* do now before Simplification comes in?

Don't assume that just because there is no requirement to buy an annuity at 75 it will be good advice not to do so. Apart from investors who are terminally ill it is difficult to see any justification for adopting ASP other than to preserve the pension capital for next of kin, and even if clients want to do this their estate could face an IHT charge.

For someone in normal health at age 75 a single life annuity currently secures an index linked income of around 8% p.a., while a joint life annuity generates over 6% p.a. rising with inflation for life thereafter. Competing against such high and rising yields is simply not realistic however good the investment strategy is. Much lower levels of income will be available under ASP.

If nonetheless clients are planning to continue income withdrawals after age 75, don't switch their funds to cash and bonds. Generally anyone in drawdown will be progressively switching into cash and bonds as they approach age 75 to avoid the risk of falling equity markets when they have to buy an annuity. If you are not going to buy an annuity this strategy is clearly inappropriate.

Don't advise clients to take benefits from Free Standing AVCs, from Protected Rights policies or from Personal Pensions subject to certified tax-free cash. Providing that the client can afford to wait until April they will get tax-free cash instead of taxable income.

Simple it won't be!

One thing is certain about Simplification, and that is that it won't be simple! It will however offer planning opportunities for clients and their advisers, some of which have a definite 'sell by date' of 5 April 2006. Ironically, the biggest risk to advisers is that they oversimplify and miss some of the complexities which will no doubt come back to haunt them and their PI insurers!