

ALTERNATIVELY SECURED PENSIONS – ABOUT TO BE U-TURNED?

The new pension regulations that came into force on 6 April 2006 included the welcome news that pension funds need no longer be annuitised at age 75.

This facility, known as Alternatively Secured Pension (“ASP”), currently provides the opportunity for pension policyholders and their spouses or financial dependants to draw an income for life while remaining invested. Following their death, any residual pension fund can be transferred to the pension fund of a nominated beneficiary, subject to inheritance tax.

The government has indicated, however, that it intends to restrict the use of ASPs to their original purpose of providing pension income to those with religious objections to purchasing annuities. Ed Balls, Treasury economic secretary, recently announced that the government will make a statement about ASPs in the forthcoming pre-Budget report, normally published in late November/early December.

The possibilities for ASP range from complete abolition to the imposition of a further tax charge, perhaps when the facility is first used. It is almost certain that any change will reduce the attractions of ASP. In any event, the amount of income which can be withdrawn after age 75 is significantly less than that which can be withdrawn before age 75 under Unsecured Pension (the new name for income drawdown). It may therefore be advisable to consider drawing pension benefits earlier than intended.

Specific advice will be provided to clients/should be sought, as appropriate, before taking any action.

CLAIM £176,000 OF TAX RELIEF

Following A-day, an individual is allowed to pay an annual pension contribution of up to 100% of net relevant earnings, subject to a limit of £215,000 gross in 2006/07, rising to £225,000 gross in 2007/08. The legislation also allows individuals to bring forward their 2007/08 annual allowance into the current tax year, thereby permitting a total gross contribution of £440,000.

Those paying the full £440,000 will be able to claim up to £176,000 income tax relief if they have sufficient earnings to warrant such a contribution, resulting in a net contribution of just £264,000. Large contributions need no longer be paid to retirement annuity policies (“RAPs”), which may have a limited range of poor performing funds and high charges.

Contribution strategies should be carefully planned to ensure that individuals do not breach:

- (a) the lifetime pension fund allowance (£1.5 million in 2006/07);
- (b) the tax free lump sum “recycling” rules (see later article).

“A BIRD IN HAND?” POSSIBLE ACTION BEFORE FURTHER REFORM

There are some politicians and academics who think that “the tax concessions on pensions savings.....overwhelmingly benefit the richest.....5% of the population” and that “the tax free lump sum is an anomaly”. These words were contained in the report of the House of Commons Work and Pensions Committee (published on 22 July 2006), whose job is to make recommendations for legislative change.

In anticipation of possible future legislative changes, individuals should be considering two things:

Firstly, higher rate taxpayers planning to make pension contributions should consider doing so sooner rather than later. This needs to be considered in the context of the overall financial plan and particularly with an understanding of the pension fund value when benefits are required.

Secondly, those aged 50 or over should consider withdrawing their pension commencement lump sums (the new name for tax free cash) now to secure the payment tax free and before any disadvantageous rule changes come into force (though see paragraph below). There are a number of implications in doing this and advice should be sought before taking any action.

It is worth noting that the removal of higher rate tax relief and tax free lump sums has been discussed many times in the past. There are some who think that Civil Servants are unlikely to countenance the removal of either; the more sceptical may disagree. Clearly, there would be uproar if the tax free lump sum facility was removed without notice. If its removal does come to pass, then the best hope is that it will be in respect of lump sum rights built up by future contributions.

Saunderson House will be keeping its finger on this particular pulse and can provide individual advice as appropriate.

If you would like our advice on any of the matters in this bulletin, please contact Nick Fletcher, Managing Director, at nick.fletcher@saunderson-house.co.uk or on 020 7315 6504 (direct), who will either help you personally or guide you to an appropriate adviser.

TAX FREE LUMP SUM RECYCLING – NO LONGER PERMITTED

Under the new pension rules, when a tax free lump sum is drawn and used to fund a pension contribution within two years, you may face a significant tax charge. The government's objective is to ensure that you cannot claim tax relief twice on the same monies.

If "recycling" is deemed to have occurred, you will be treated as though you received an unauthorised payment, which could result in a tax charge. This could be up to 55% of the tax free lump sum withdrawn and, potentially, a sanction charge of a further 15% to 40% payable by the scheme. There are four conditions which must be satisfied for "recycling" to have taken place, the most prominent of which is that the "recycling" must have been pre-planned.

Strategies for taking benefits should be carefully planned to ensure that individuals do not breach the above rules. Advice should therefore be sought on pension contributions and withdrawals.

BEWARE OF PARTIALLY TRANSFERRING PENSIONS

From 6 April 2006, not all pension transfers are permitted and a breach would result in the loss of Enhanced Protection thereby incurring significant and unnecessary tax charges on taking benefits or earlier death.

The most common instance of a non permitted transfer will be a partial policy transfer. For example, if you have more than one arrangement under a scheme, or a scheme is segmented but you only transfer one arrangement or segment, this will be a partial transfer. The transfer of an AVC fund whilst retaining the principal scheme is therefore not permitted. If a scheme is divided between protected and non protected rights, these can be transferred to separate schemes provided that the transfers are simultaneous.

Care should be taken to ensure that schemes are properly analysed before transfers take place, particularly where the scheme is segmented. As ever, expert advice should be sought when contemplating any pension transfer.

UK COMMERCIAL PROPERTY - HIGH RISE VALUATIONS WILL COME BACK DOWN TO EARTH

Commercial property has been the best performing major UK asset class over the last six years. Strong capital growth has driven down property yields and we now believe that the asset class looks unattractive on valuation grounds. We have therefore recommended that our clients begin to reduce exposure to this sector by taking some profits where applicable.

Commercial property (both in the UK and internationally) has now become the asset class of choice for many advisers, private investors and now corporate pension funds. This has resulted in fund closures (to avoid diluting existing investors' holdings), the imposition of large bid/offer spreads and some listed property funds trading at premiums to net asset value. Paradoxically, these actions may have spurred investor enthusiasm further, giving property exposure a "scarcity value".

High prices are prompting increased supply in the commercial property market. Construction of City office space is up by 80% in 2006 compared to 2005. Much of this is speculative, that is, the builders have no tenant signed up to take the additional space. We believe that (a) this new supply will eventually act to slow rental increases and commercial property returns and (b) the likely introduction of Real Estate Investment Trusts ("REITs") in 2007 may already have been priced into the market.

Some property investors are disposing of City commercial property assets. This may be an indication that they believe returns are not sustainable at current levels. As well as the now famous 'Gherkin' being put up for sale by Swiss Re., other assets for sale include a £1.8 billion portfolio owned by Simon Halabi and the Lion Plaza office block in Old Broad Street.

Special circumstances may lead to individual properties continuing to increase in value. The strong run in the value of UK commercial property in general may continue in the short term. We believe, however, that the fundamentals will reassess themselves in the medium term and that, as this takes place, investors in commercial property will suffer a period of poor returns.

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It is important to note that the value of many investments and the income derived can fall as well as rise. Few investments are guaranteed and you may not get back the amount you originally invested. Past performance is not a guide to the future. All taxation is based on our current understanding of the law, which may change in the future from time to time. For Unsecured or Alternatively Secured Pension policies you should note the following: High income withdrawals may not be sustainable during the (annuity) deferral period. Taking withdrawals may erode the capital value of the fund, especially if investment returns are poor and a high level of income is being taken. This could result in a lower income if and when an annuity is eventually purchased. Annuity rates may be at a worse level if and when annuity purchase takes place than are available now or indicated in any illustration. A certain investment return is required simply to "keep pace" with an annuity, because an unsecured pension withdrawal fund does not receive a benefit from the early death of other pensioners, as does an annuity. This lack of subsidy possibly requires a return of 1-2% per annum above that which could be obtained from the medium-long dated gilt investments on which annuity rates are based. This effect is known as mortality drag. Even if investment returns are strong, there is a possibility of the future income reducing if there is a significant decline in the factors affecting the GAD rate. These factors are the yield on medium-long dated gilts and mortality rates. If the purpose of the unsecured or alternatively secured pension is to "beat the annuity rate" (attempt to purchase an annuity when rates are higher whilst also maintaining the overall level of income that could have been provided through annuity purchase), investment in (more risky) equities is necessary in order to simply overcome the effect of mortality drag; City forecasts are for equities to outperform gilt investments by only 2-3% per annum over the next few years, so the chances of "beating the annuity rate" are remote if this forecast is correct. If an annuity has not been purchased by age 75, the maximum income from an alternatively secured pension after age 75 is significantly less than the maximum that applied before age 75 under an unsecured pension.