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Newsletter: June 2021

Understanding Modern Pension Plans – Part I

In the last two months' newsletters, we have considered how we might help families to transfer wealth between generations.

Historically, arrangements for providing pension income in retirement saw any benefit cease on the death of the pension plan holder or their spouse. Therefore, pension plans could not form a component of a strategy for transferring wealth down the generations.

However, pension legislation has changed and modern pension plans have new features, including the ability to pass the pension fund down generations.

In our next three newsletters, we are going to explain how modern pension plans operate and consider the main benefits which can be offered to young investors, accumulating a pension fund; retiring investors, looking to start taking benefits from their pension funds and older investors thinking how their pension funds may form a part of a strategy for transferring wealth.

Background

Pension tax simplification, often simply referred to as "pension simplification", which took effect from A-day on 6 April 2006, was a policy announced in 2004 by the Labour government to rationalise the British tax system, as applied to pension schemes.

The aim was to reduce the complicated patchwork of legislation built-up by successive administrations, which were seen as acting as a barrier to the public when considering retirement planning.

The government wanted to encourage retirement provision by simplifying the previous eight tax regimes into one single regime for all individual and occupational pensions.

What has happened over the last 15 years? It could be argued that, to some degree, things have been made simpler and will, hopefully, continue to become ever more so with fewer tax regimes and the diminishing need to refer back to April 2006.

However, it could also be argued that pension legislation is as complicated as ever. As an example, the Lifetime Allowance, a concept introduced in April 2006 which set a limit on the amount of pension benefit that can be drawn from pension schemes without triggering an extra tax charge, is currently set at the easily remembered sum of £1,073,100!

We thought it would be useful to do our bit to try to make things as simple as possible in order to encourage people to make the most of modern pension plans.

How do pensions work?

A pension contribution is viewed for tax purposes as being a deferral of income until later life. Therefore, the UK tax system allows pension contributions to be made from gross income.

If you contribute to your own pension, you make the contribution net of basic rate tax and the pension plan provider then reclaims the basic rate tax from HMRC.

If you are a higher rate taxpayer, you can claim the higher rate tax through your tax return.

So, if you are a higher rate taxpayer and you contribute £80 per month to your pension, the pension plan provider will reclaim £20 per month tax from HMRC and invest £100 per month on your behalf. You will then be able to claim a further £20 per month in higher rate tax relief through your tax return.

If your employer contributes to your pension plan, they contribute the gross sum.

Your contributions start to accumulate a fund and this is allowed to grow virtually tax-free. This can be a significant benefit, especially over the longer term.

For most of us, we can only start drawing any benefit from our accumulated pension plan once we reach the age of 55.

We are allowed to withdraw up to 25% of our accumulated pension fund without any liability to tax. Therefore, on one quarter of your pension fund, you have not had to pay tax at any time. Any money you withdraw over and above the 25% tax-free amount will be treated as taxable income.

Remember, your pension fund has been accumulated by deferring some of your income until your retirement. The amount you contributed was taken from gross income and, therefore, not subject to tax and your fund has been allowed to grow virtually tax-free. So, it is now that HMRC would like their slice of the cake.

Why contribute to a pension?

Retirement can be viewed as an extremely long holiday, especially with us all living longer. We tend to think of retirement happening at around the age that the State Pension starts, which, depending upon your age, could be between 66 and 70. On average, we are living well into our 80s so, for most of us, retirement is likely to last for 15 years or more.

The State Pension provides less than one third of the average earnings in the UK. Therefore, there is likely to be a significant drop in income from the last day we work, to the first day of our retirement, unless we make sensible provision.

The impact of tax relief on pension savings is also significant. If we invested £10,000 gross into a pension, we will only have to invest £8,000 net as a basic rate taxpayer or just £6,000 net as a higher rate taxpayer.

If we invest this amount over a 40-year period assuming the same rate of growth of 3% per annum compound within a pension and a non-pension investment, the pension contribution would accumulate a fund of £776,600 whilst the basic rate taxpayers non-pension investment would only grow to £621,300 with the higher rate taxpayer only accumulating a fund of £466,000.

How much can I contribute?

You are allowed to contribute up to 100% of your salary with a maximum contribution allowed each year of £40,000.

Clearly, being able to contribute all of your salary is unlikely in most circumstances but could be considered if you had recently come into some money, such as inherited some money from a relative.

How much should I contribute?

This is a trickier question to answer. Many years ago, before 1990, contributions to personal pension plans were limited to 17.5% of earnings.

This figure was not plucked from thin air. It was a calculation carried out to determine how large a fund the pension contributor would require at age 65 (the State Pension age at that time) in order to provide them with pension income equal to 2/3 of their salary at the point they retired.

So, we would suggest endeavouring to contribute at least 10% of your salary and preferably a little more.

With tools such as cash flow modelling spreadsheets, it is a fairly straightforward exercise to calculate how much you need to contribute in order to accumulate the size of fund that you think you will need in order to provide a satisfactory income for your retirement.

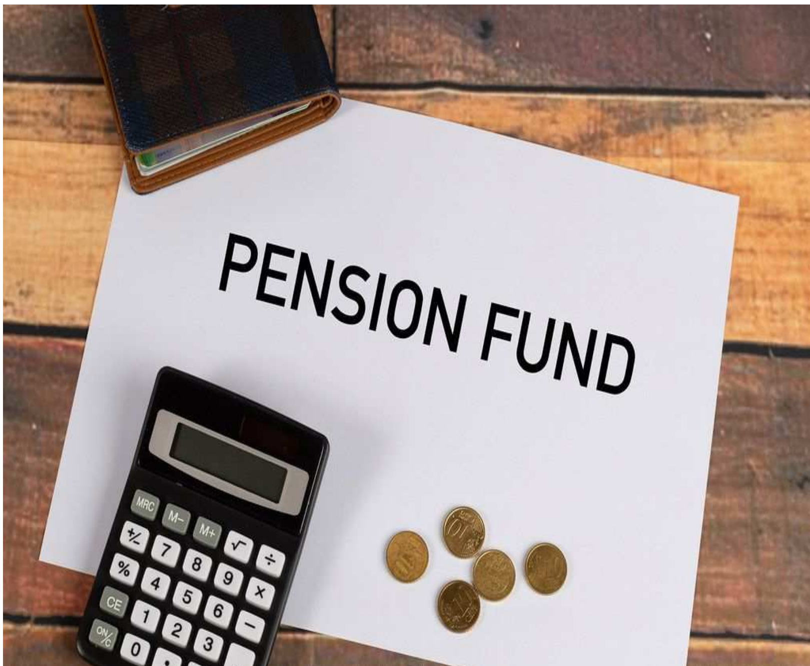
To help more people save for their retirement, employers are now obliged to provide Workplace pensions for their employees. Some employers will contribute more than the statutory minimum (a combined total of 8.0% of your qualifying earnings) if their employees also agreed to pay more. In this situation, the employer is effectively offering a higher salary, albeit deferred until your retirement, but it would make complete sense to contribute as much as you could afford.

When should I start contributing?

The simple answer to this question is to just be aware of the benefits of compounding investment returns.

As a straightforward comparison, consider Mr Wise commencing a pension contribution of £500 per month at the age of 30 and compare the fund value at age 67 with Mrs Morecambe who waits to start the same pension contribution until age 40.

Based on a 3% per annum compound return, Mr Wise would have a fund of £409,000 whereas Mrs Morecambe's fund would only be £251,500!



What happens if I do not make retirement?

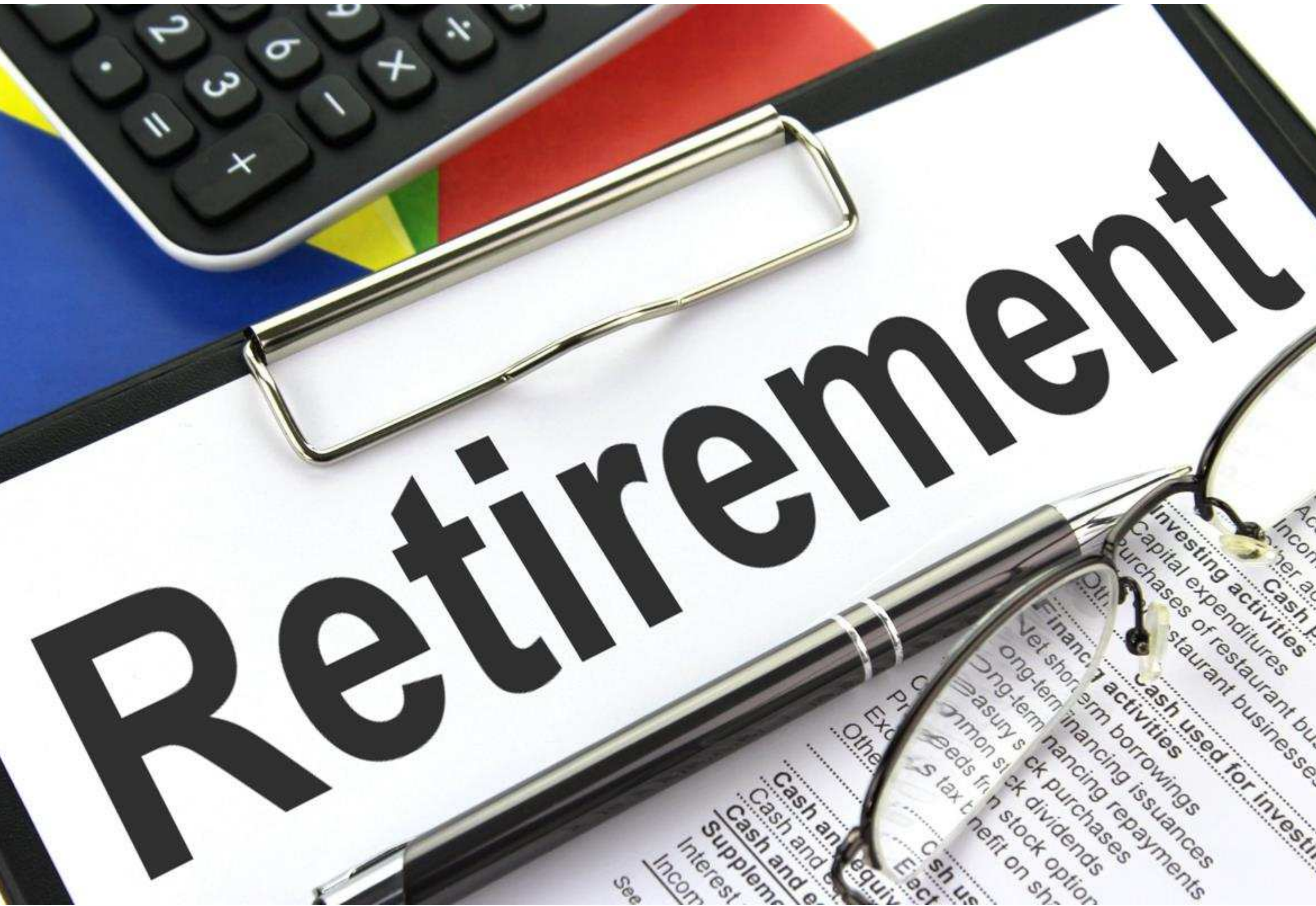
Pension funds are held under a form of discretionary trust and do not form part of your estate. Therefore, they are not distributed under the terms of your Will.

Instead, you can make a nomination as to who you would want to benefit in the event of your death. If you died before retirement, your beneficiary or beneficiaries could inherit your pension fund free of any tax liability.

The situation is a little different for those aged over 75, which we will discuss in the third newsletter of this series.

In summary, for those still accumulating their pension funds, pension legislation has been made a little simpler.

Furthermore, options at retirement have been significantly increased, which means that pension funds can be accessed more flexibly than they could be in the past. We will consider the various options in next month’s newsletter.



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Market data

Market	Value at start of 2020	Current situation	Comments
Interest Rates (BOE base rate)	0.75%	0.1% at 31/05/21	The official bank rate is 0.1%.
House Prices (Nationwide)	House prices increased by 7.3% in 2020	House prices up by 1.8% in the month to 31/05/21	Annual house price growth up 10.9%.
UK Share Prices (FTSE 100)	7542.40	7022.60 at the close on 28/05/21	The FTSE 100 rose by 52.79 points in May.

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