Personal Finance

MAJOR PENSION CHANGES A WAKE-UP CALL FOR EVERYONE

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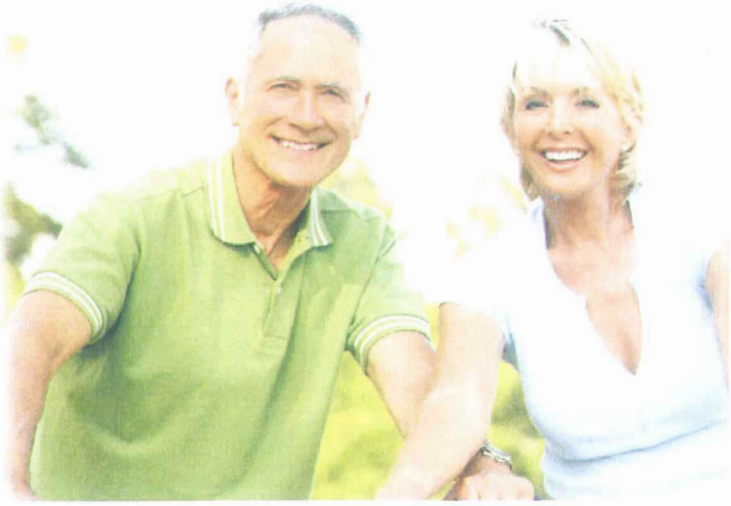

In this year's spring budget Chancellor George Osborne stated the UK government's intention to dramatically reform the way in which members of UK-registered defined contribution pension schemes could access their savings. Up to now, savers are obliged to take an annuity upon retirement and can access only 25% of the value as a tax-free lump sum. From 6 April 2015 it is proposed that members will be able to access the entire amount subject to paying tax at their marginal rate on any amount above the tax-free allowance.

This would appear to be a complete reversal of the previously accepted wisdom of ensuring that pensions would provide an income for life and that pensioners would therefore not become a burden to the state if their pensions ran out. The attitude the Chancellor has taken is that the British public are grown up and mature enough to manage their retirement funds without government inteference. I would suggest the Chancellor has little understanding of human nature or the temptation for people who have never had an opportunity to get their hands on a large sum of money.

If the proposals go ahead I suspect that pension providers will see a surge in requests from individuals at age 55 and over to fully withdraw the capital in their pension funds, irrespective of the 30% or more they will have to pay in tax. A massive drawdown could also spell big trouble for the hundreds of pension schemes that are already seriously underfunded in the UK. Some people will undoubtedly reinvest their money wisely but a large number will inevitably spend their windfall irresponsibly and then turn to the state for help when they are destitute.

There is however a strong argument for abandoning the annuity route. Since annuities are linked to government bond rates the income from annuities has been miserably low for a number of years. That, coupled to the fact that an annuity dies with the holder and his spouse, has provided justification to find a better option. But that still leaves a stark choice between having just a small income for life or having more now but nothing later. Then again, one wonders to what extent the government is licking its lips at the thought of the huge tax bonanza it is going to collect from next April. But who is going to pick up the tab when millions of pensioners run out of money? Future taxpayers? Or perhaps no-one at all and pensioners will be left to their own devices.

What about state pensions?

There has been much fanfare about the proposed flat-rate pension in the order of GBP155 a week to be introduced in 2016. But only a minority of pensioners will qualify for the full amount according to recent reports in the British press. Anyone who has paid less than 35 years' contributions or who was a member of a company

scheme that contracted out of paying full contributions could find himself receiving a much smaller amount.

And there is unlikely to be any respite for half a million UK pensioners living in certain countries including Indonesia whose pensions will continue to be frozen at the level they received when they left the UK. This would be the perfect opportunity for the government to bring those pensioners in line but it seems unlikely as successive governments have shown little interest in the anomaly. One elderly lady in Australia is reportedly receiving six pounds a week even though she, like many others, paid her contributions to the state in full during her working life. Fortunately for her, the Australian government has stepped in to help; the same is true for cases in Canada. It should be an embarrassment to the British government but it seems not. As far as Whitehall is concerned, expatriates are out of sight and out of mind. A globally active group, which has a branch in Bali, has been fighting this injustice for years but so far to no avail.

What about company pensions and QROPS?

Once upon a time working people could look forward to pensions for life linked to their final salaries. Such pensions were established in the days when life expectation was much lower and returns on stock market investments were much higher. Such pensions are no longer sustainable and have steadiliy been replaced by pensions where members share the market risk. It is impossible therefore to predict what the eventual pension will be worth until retirement time comes. Under present rules the resulting lump sum must be converted into an annuity. Under the proposed new rules the member will be free to either convert to an annuity as before or take as much of the lump sum as he wishes, subject to a hefty tax on any amount above his tax-free limit. Whether he takes the full amount immediately or later the tax will still apply.

Long term expatriates who belong to UK company pension schemes have for several years been able to escape the shackles of annuities by transferring their holdings to an offshore QROPS (Qualififying recognised overseas pension scheme). These schemes will still impose limits on annual drawdowns but those limits are being relaxed. Furthermore most schemes still have the attraction of allowing a 30% tax-free drawdown as opposed to 25% in the UK and perhaps above all an ongoing tax rate which can be as low as 2.5% per annum on future withdrawals. A QROPS can also mitigate tax liability on death. But monitoring these schemes has been a big headache for HMRC and with the proposed pension changes we may see the window of opportunity for QROPS closing. The message is, if you belong to a company scheme in the UK, look at the options now before it is too late.

What are the practical implications for all of us?

All the above may be of little relevance to expatriates who have no UK or home-based pensions. In such cases it is critical to have alternative arrangements in place. One of the most popular vehicles for building up wealth over time is a life company-linked savings or pension plan. These generally have no restrictions and can be taken as a lump sum or an income on maturity with no tax deducted at source (although gains are subject to income tax depending on country of residence at the time). A downside is that they require a commitment to the contracted period. Breach of the conditions can be costly. Nevertheless they do offer a disciplined means of building up savings.

What other alternatives exist?

Any form of savings or investment that has retirement as an objective may be considered as a form of pension. Two of the favourites are:

- Portfolio Bonds. These are vehicles provided by every major life company and consist of an open platform which can contain any number of approved funds (subject to minimum amounts) out of a universe of thousands of funds. The portfolio can be established with a single lump sum investment and can topped up over time. 'Mini-bonds' are more economical for investments below GBP 100,000.
- Property. A good property in the right location can provide a regular income in retirement. It does have its drawbacks in that it may take a lot of your time to oversee. Managed investment properties are an alternative worth considering. One company in the UK for example offers purpose-built apartments from only GBP100,000 that require just a 30% deposit payable over two years. A management company then pays a guaranteed rental that covers the mortgage. Once paid off you have a property which will have cost you, if all goes according to plan, just 30% of the original price. From then on you would have an income for life.

  The risks of course of property ownership must be considered as well as those of financial investments.

So which kind of pension is best? If you are fortunate enough to have one, the best pension is probably one that is linked to your final salary and indexed to inflation. But such pensions are disappearing fast.

Even with such a pension it is wise to have several strings to your bow. Expats should ideally have at least a couple of regular savings plans and a portfolio of stocks, bonds and commodities together with property investments (apart from the family home) that can produce a steady income. Plus of course healthy cash reserves.

When should you start saving for retirement?

The day you start working! Left it a bit late? Better drop me a line. Left it much too late? I'll be happy to offer sympathy and a cup of coffee in Starbucks below my office!