review

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Crystal Wealth Management

Pensions tax relief under threat again

Tax relief on pensions is likely to be more and more restricted in the future. This has been the trend of recent years and seems likely to continue regardless of which party or parties form the next government after the 2015 election.

At present, contributions are subject to full tax relief, which is why they are so attractive for many people. Basic rate and even non-taxpayers get 20% relief, so that a £1,000 contribution effectively costs them a net £800. To the extent that you pay 40% tax on your income of over £41,450, you can claim back an extra 20%, so that a £1,000 pension contribution effectively costs you £600. And if your income exceeds £150,000 and you are therefore a 45% taxpayer, your £1,000 pension contribution will cost you just £550. What's more, an employer's pension contribution also saves national insurance contributions of up to 13.8% for employers and either 2% or 12% for employees.

The politicians have their eyes on pensions tax privileges for two main reasons – cost and fairness.

Pensions tax relief represents a great deal of money. Altogether the total cost in 2011/12 was just short of £50 billion according to HMRC. Nobody is looking to save all this amount, but they are thinking of ways to cut the cost.

There is also the perceived unfairness of the system in giving the greatest tax benefits to those with the highest incomes. Earlier this year, the Pensions Policy Institute suggested that everyone should get the same level of tax relief on pension contributions.

Ed Balls backed this general approach at the 2013 Labour Party Conference with a call for the pensions contribution relief for the "highest earners" to be restricted to "the same rate as the average taxpayer". Also this autumn 40 Conservative MPs representing the party's most marginal seats published a paper containing 40 policy ideas to attract swing voters. This included abolishing the higher-rate pension tax reliefs at an estimated tax saving of £7 billion.

In comparison, the LibDem proposals to continue the trend of bringing down the lifetime allowance from £1.25 million to £1 million seem quite modest. The moral is that if you are a higher rate or additional rate taxpayer you should be considering how to invest into your pension the maximum you can afford.

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How much income will you need in retirement?

How much income will you need after you have retired? The number crunchers at the Department for Work and Pensions (DWP) have published a report that tries to answer this eternal question, with interesting results.

"Two thirds of final salary" used to be the answer to the income-in-retirement question, based on nothing more scientific than the fact that this proportion was equivalent to what the old Civil Service Pension Scheme provided for its long serving (40 years +) employees.

These days a more sophisticated analysis is made to determine what constitutes an adequate retirement income: the target is a level of income for retirees which, in the DWP's words, "allows them to maintain the same sort of lifestyle in retirement which they had whilst in work." This is still expressed as a percentage of earnings, but the DWP takes average inflation-adjusted earnings between age 50 and State Pension Age.

50/State Pension Age Average Earnings Band	Replacement Rate for Adequate Retirement Income %
Less than £12,200	80
£12,200 - £22,400	70
£24,400 - £32,000	67
£32,000 - £51,300	60
Over £51,300	50

The DWP's table gives it a starting point to gauge the adequacy of future retirement income in the light of two major pension reforms currently underway:

- Automatic enrolment in pension schemes for employees, which started for the largest employers last October but will not be fully operational until 2018; and
- The replacement of the current Basic State Pension and State Second Pension (S2P) with a new Single-tier State pension from April 2016.

These significant changes have less impact than you might expect. The DWP says that the reforms will "reduce the number of people facing inadequate retirement incomes by 1 million", but there will still be "an estimated 12.2 million people facing inadequate retirement incomes." Of that number, the DWP says "Roughly half of these are within 20% of their target amount, with the remainder facing a more significant challenge." This is a particular issue for moderate and higher earners. ... Those on moderate or higher earnings may want to save more than automatic enrolment defaults to reach adequate incomes." "May want" is putting it mildly – '*will need*' is probably more accurate.

The value of your investment can go down as well as up and you may not get back the full amount you invested. Past performance is not a reliable indicator of future performance.

Should you protect your pension now?

The lifetime allowance falls next April, but you can claim protection from the cut.

On 6 April 2014, the lifetime allowance – effectively the maximum tax-efficient value of all your pension benefits – will drop from £1.5m to £1.25m. If the Liberal Democrats get their way, there will be another reduction to £1m, after the next election.

There are two sets of transitional relief which will allow you to shelter your current pension rights from the April revisions. The first, Fixed Protection 2014, will preserve your lifetime allowance at a minimum of £1.5m, but it must be claimed by 5 April 2014. However, a claim would mean that, broadly speaking, after that date you cannot benefit from any further contributions or benefit accruals.

The second relief, Individual Protection, is more complex and will not be finalised until the Finance Act 2014 receives Royal Assent next summer. It is only from then that any claim for this relief can be made.

If you have pension benefits that could be affected, please contact us now to start a review of your options.

The value of tax reliefs depends on your individual circumstances. Tax laws can change. The Financial Conduct Authority does not regulate tax advice.

Another view on annuities

Another annuity table has been published, giving new insights into the huge variability in rates.

An annuity is the annual income you can buy with your pension fund when you start drawing your pension benefits. It is a one-off decision that will determine your pension income for the rest of your life. You can buy an annuity that will just last your lifetime and it need not have any inflation protection. But you can have an annuity that will last not just your lifetime but also that of your spouse or civil partner, and it can be inflation-proofed to a greater or lesser extent. The cost of an annuity depends on whether you inflation-proof it and whether add in your spouse/partner; but it also varies with your age and state of health and even where you live at the time you make the purchase.

The Association of British Insurers (ABI) – effectively the annuity providers' trade body – began publishing specimen annuity rates. The ABI tables are rather different from those which appear elsewhere, such as on weekend press financial pages. They cover just twelve "fictional customer profiles", all based on age 65 and none using the current rates (in October the ABI tables were showing figures for September).

The ABI has obtained annuity rates from those of its members which only sell annuities to their own pension policyholders, so its tables capture many annuity providers that do not appear in other league tables. The results have highlighted the large disparity in annuity rates on offer. The brief table here shows the differences in annual income for a 65 year old with £18,000 to invest.

	No health problems	Smoked for at least 10 years, lung disease, severely impaired
Best Rate	£1,706.56	£1,997.40
Median Rate	£1,521.06	£1,841.82
Worst Rate	£1,350.57	£1,350.97
Best/Worst Ratio	126.4%	147.9%

Even this rate table does not tell the whole story, as some providers chose not to quote for the severely impaired profile because they did not offer underwritten annuities.

If you are at or nearing the point when you plan to start drawing benefits from any pension plan, the lesson is obvious: do not assume your current provider will give you the best annuity deal. To find the annuity – or other retirement income option – that fits your circumstances, you need to take professional advice and we are here to help.

Forward guidance goes backwards

The world's central bankers have a new interest rate tool: it is called 'forward guidance'.

Imagine you are the Governor of the Bank of England. How would you convince everyone that interest rates are going to stay at current low levels for several years?

If you do not want to be a hostage to events over which you have no control, the best you can do is offer a firm steer that you will keep interest rates unchanged until certain events occur (this is "forward guidance" in the jargon).

This is where we find ourselves now in the UK (and, for that matter, the US). The (relatively) new Governor of the Bank of England, Mark Carney, announced in August that the Bank's Monetary Policy Committee "intends not to raise Bank Rate from its current level of 0.5% at least until … the unemployment rate has fallen to a threshold of 7%", which the Bank's economists predict will be in mid- 2016.

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If the thought of nearly three more years of 0.5% base rates fills you with dread, then you may take some solace from the reaction of the financial markets to the Bank of England's forward guidance: they do not seem to believe it. By September the pattern of interest rates in the money markets suggested that base rate should rise around the end of next year, 18 months earlier than the Bank had in mind.

On both sides of the Atlantic, "forward guidance" has proved more difficult to convey than central bankers anticipated. However, for investors, the thrust of the message is relatively clear. If you think interest rates will rise soon, you are betting against the central banks. As a result, money you hold on deposit looks set to continue a losing battle against inflation and tax – if you are a higher rate taxpayer, you need 4.5% gross interest to counter the effects of 2.7% inflation and 40% tax.

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Dow Jones has a rethink

The venerable index has undergone its biggest change in almost a decade.

The Dow Jones Index – strictly speaking the Dow Jones Industrial Average – is probably the most widely quoted share index, not least because of its age. The index has only 30 shares and in September three companies (Hewlett-Packard, Alcoa and Bank of America) were thrown out and three new constituents (Nike, Visa and Goldman Sachs) were introduced.

You might have expected Apple and Google – the first and third largest US companies by market value – to join the Dow, but they remain outside the index. The reason for their exclusion (and, for that matter, Microsoft's and IBM's continued inclusion) is the old fashioned way in which the Dow is constructed.

The Dow thus serves as a good reminder that when using indices for comparisons or as the basis of tracker funds, it is essential to understand just how your chosen index is put together.

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Keep up with your financial protection needs

At least every two or three years, you should take a good look at your life assurance to see if it still provides what you need. When you are making such an important review, it is almost always worth going back to basics to consider the types of cover you need, how much you should have of each one and how long you are likely to require protection.

You need life assurance if there is anyone who would suffer financially as a result of your death. Assessing how much life cover is required may seem a slightly dismal exercise, but it is essential to think through the financial consequences of your possible demise.

Once your earnings vanish, the various family expenses you pay for and domestic labour you provide would have to be covered from some other source – such as the proceeds of a life policy. The need for life assurance is especially great if you have dependent children; and that means both parents need life cover.

The insurance company Legal & General has carried out some research into this subject and concluded that the annual value of a parent is £31,627 for a mother and £23,971 for a father. The average total day-to-day cost of raising a child to the age of 18 is £154,440 – without any school fees and many of the other extras that you may be paying for now.

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One of the troubling conclusions of the Legal & General report is that inflation is actually far higher for most families than government statistics suggest is true for the population as a whole. For example, the insurer found that the value of a father has increased by 13% since 2011.

Your employer may provide some life cover, but it is unlikely to be enough. You should not just leave the need for protection of your family to chance. Most people find it easier to make the right decisions about life cover by talking them through with an experienced and trained adviser who can suggest the right types of policy, the level and term of cover required and the most suitable trust arrangements.

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Premium Bond prizes shrink

From 1 August, National Savings & Investments (NS&I) cut the prize money interest rate of premium bonds from 1.5% to 1.3%.

From 1 August, National Savings & Investments (NS&I) cut the prize money interest rate of premium bonds from 1.5% to 1.3%. The change mirrored short term interest rate cuts elsewhere, even though base rate has been unchanged since March 2009.

To cope with the reduced prize pot, NS&I reduced the odds of winning in the monthly draw from 24,000:1 to 26,000:1. NS&I also rejigged the prize distribution, so that 98.5% of all prizes are now £25. As for the odds of winning the single £1m jackpot in any one month, these are now less than 1 in 46,000,000,000…