

**Berg Kaprow Lewis**

Personal pension schemes

The basic state pension, for an individual, is currently £82.05 a week. To boost your income in retirement, you need to make your own arrangements. You can choose between a variety of schemes, many of which were originally devised to take advantage of tax breaks.

Recent reform of the tax regime, with the introduction of an annual limit on tax-favoured contributions from earnings (£215,000 in 2006/07), and a lifetime limit on tax-favoured savings (£1.5 million in 2006/07), has meant that many of the original restrictions have been swept away, and it is possible that the form of the schemes will change as a result.

It is possible to save a much higher level of income for retirement, and to save it simultaneously through a much wider range of schemes. You can use your occupational pension scheme (see **Company pension schemes**), a stakeholder scheme (see **Stakeholder pensions**), a personal pension, and one or more forms of top-up arrangement (see **Executive pensions**), all at the same time. In this briefing we look at personal pensions.

This briefing explains:

- Who should take out a personal pension.
- How much to pay in.
- How to choose a scheme.
- Where to go for advice.

1 Should you have one?

The sooner you start saving for retirement, the better. But check any long-term contracts. Nearly all modern pension schemes permit you

to move your money out without charges, but others have penalties.

1.1 Certain people are **generally advised** to make their own pension arrangements:

- Anyone who would otherwise rely solely on a state pension.
Even if the basic pension is supplemented by a State Second Pension (formerly SERPS), this will not normally pay for a comfortable retirement (see **National Insurance and state pensions**).
- The self-employed.

1.2 If you belong to a company pension scheme, you could use a personal pension scheme to **top it up**.

Directors' Briefing

a book in four pages

More than 160 briefings are
now available.

If you need further information or help,
ask the distributor of this briefing
about the services available to you.

- Following the tax simplification implemented in April 2006, members of company schemes can now save up to £215,000 each year towards their retirement, with tax benefits providing they observe certain restrictions (see **2.1**, below).
- Opting out of a company pension into a personal pension is unlikely to make sense, because company schemes generally offer better benefits, most notably the employers' contribution.

1.3 Some people are **excluded** from investing in personal pensions.

- Those who are aged over 75.
- Those who are not resident in the UK for tax purposes (except for Crown Servants serving abroad, their spouses or civil partners).

2 Tax breaks

Tax relief on your contributions to personal pension arrangements will boost your savings.

2.1 Following tax simplification, you can pay as much as you like into one or more pension schemes. But there are conditions for obtaining **tax relief**:

- The scheme(s) to which you are contributing must be HM Revenue & Customs registered (ie approved).

Your dependants

You can provide for your dependants by taking out a personal pension plan.

- A** A **lump sum** will be paid to your heirs if you die before retirement.
- This will usually be the value of your fund at the date of death or – very rarely – your contributions plus interest or bonuses.
- B** You can use as much as you like of your allowable contributions to take out **life assurance**, to give separate lump sum cover should you die before taking benefits.
- These payments qualify for tax relief, unlike most life assurance premiums.

However, the inheritance tax treatment of any payout has not yet been settled. To be on the safe side, you should assume that inheritance tax will be payable.

- You can obtain tax relief on up to 100 per cent of your contributions to these scheme(s) providing they (plus your employer's contribution) fall short of the 'annual allowance' (£215,000 in 2006/07).
- The contributions in question must come from your earned income, from up to £2,808 (net) of unearned income, or from your employer.
- Any contributions in excess of the 'annual allowance' will be taxed at 40 per cent.

2.2 You will receive tax relief up to your **top rate**.

- Tax relief at basic rate (22 per cent) is now given automatically. So you only have to pay in £78 to get £100 invested in your pension.
- Higher rate taxpayers are entitled to relief at 40 per cent on their contributions. Individuals must claim the additional 18 per cent tax relief back through self-assessment tax returns.

2.3 Unless you are **barred** from joining at all (see **1.3**), you can currently pay up to £2,808 a year (ie £3,600 a year with the tax refund) into personal pension schemes, whatever your income.

- Even people with no income at all can pay up to £2,808 a year.

2.4 Providing that the total value of your pensions does not exceed the '**lifetime allowance**' (£1.5 million in 2006/07), you can take it free of any tax charge.

- Insofar as it does exceed the 'lifetime allowance', any benefits taken as a lump sum will be taxed at 55 per cent.
- Any benefits taken as a pension will suffer tax at 25 per cent.

2.5 Subject to the 'lifetime allowance', you can usually **take out** up to 25 per cent of your accrued personal pension fund tax-free on retirement.

- The rest of the pension fund may be used to buy a lifetime annuity, or a short-term annuity, or take income withdrawal.
- If you reach age 75 without buying an annuity, you can take out an alternative secured pension fund.
- You can convert this into an annuity at any time.
- Income drawn from an annuity or secured capital is taxed as earned income.

2.6 In order to qualify for tax relief, you cannot usually receive your pension before **age 50**. This is due to rise to 55 by 2010.

➡ Since 5th December 2005 civil partner employees must be treated in the same way as married employees. If a benefits package (such as pension survivor benefits) is available to an employee's spouse, it must also be available to an employee's civil partner.

A civil partner who is treated less favourably than a married person in similar circumstances will be able to bring a claim for discrimination on grounds of sexual orientation.

- You can choose to take your pension at any time between the ages of 50 and 75.
- If you have more than one pension plan, they can be paid at different ages.

3 How much to pay in?

3.1 The general rule is to pay in **as much as possible**, as rising life expectancy means retirement can last a long time.

- Ideally, you might plan to start paying 15 to 20 per cent of your salary into your pension before age 25, in the hope of getting a pension of two-thirds of your final salary by the time you are in your late 60s.
- The minimum you can invest in most personal pensions is £50 monthly, or £500 to £1,000 as a lump sum. You can invest smaller amounts in stakeholder pensions.

3.2 In theory, you should start contributing to a pension **as soon as possible**.

- A five year delay in starting a pension, for example, from 40 to 45, could reduce your final pension by almost 40 per cent.
- You may be able to make lump sum payments as well as your regular contributions, now that the rules have changed to allow you to claim tax relief on up to 100 per cent of your earnings.

Contracting out

The State Second Pension offers benefits to people earning up to £11,200 a year, who cannot usually afford personal pensions. People earning more are encouraged to 'contract out', through rebates of their National Insurance contributions.

- A** If you contract out, your **NI rebates** will be paid into your personal pension plan (or stakeholder pension).
- The rebate is an age-related percentage of earnings that rises as you get closer to retirement. It has also been designed to be more favourable to low-earners.
 - With a 'rebate-only' pension, you pay in no premiums, other than the NI rebates.
- B** Whether you are better off contracting out or not depends on your **age and earnings**.
- Take financial advice on your own specific circumstances.

4 What to look out for

Your retirement income depends on the age at which you retire, how the fund performs, charges deducted along the way and future annuity rates.

4.1 Choose a pension fund with a sound track record of **investment performance**.

- There is no guarantee that a fund will continue to perform well. Take professional advice before committing to a fund.

4.2 Compare the pension plan's **charges** with the charges of other plans. High costs can reduce your pension significantly.

- Charges cover marketing and selling, administration and fund management. In some schemes, initial charges can mean that only 89p in every £1 of premiums is invested in your pension in the first five years.

4.3 Flexibility is important, as the future is not predictable.

- Can you suspend contributions, or reduce or increase premiums? Are there financial penalties for doing so?
- Can you transfer your pension, with little financial penalty, to a new scheme? The 'transfer value' of different plans with the same value can vary dramatically. Most modern schemes allow you to change contributions or transfer your fund without financial penalties.

4.4 People with **irregular income** may choose to pay single (lump sum) contributions, rather than regular contributions.

- This is to avoid paying penalties for stopping and starting contributions in longer-established schemes.

4.5 Interest rates when you retire will affect the pension you receive. Annuity rates are determined by long-term interest rates.

- If long-term interest rates are high when you retire, you will get a good pension.
- If long-term interest rates are low, your pension will be relatively poor.
- You can delay buying an annuity indefinitely and instead take 'income withdrawal'. This lets you preserve your capital and take cash directly from your pension fund. But you should make sure you understand the risks of taking this choice. Get professional advice before you commit.

- If your income at the time you retire will be sufficient, you can choose to buy a smaller immediate pension, which protects against the effects of inflation.

5 What kind of pension plan?

Once you have decided on a personal (or stakeholder) pension, you need to decide what kind of investment you want. The type of investment that is right for you depends on the balance you seek between risk and reward.

5.1 With unit-linked plans, your fund is split into equal 'units', which rise and fall with the underlying value of the investments.

- If your fund is invested in shares, it should perform well over the long term, but its short-term value could be very volatile.
- You can limit the volatility by investing through 'managed funds', which hold a wide spread of investments.
- Most investors switch to safer cash or gilt funds as they approach retirement.

5.2 In a with-profits plan, you get a share in the profits of the fund, rather than a share in the fund itself. Your investment is less vulnerable to stock market volatility, but is more likely to have penalties if you transfer the fund to another provider.

5.3 Most modern with-profits plans are 'unitised' — designed to combine the virtues of both unit-linked and with-profits plans. For example:

- Your fund will be boosted each year by an annual (or 'reversionary') bonus.
- You are likely to receive a 'terminal' bonus when you retire. The size of this bonus is not guaranteed. It depends on the performance of the stock market and the company's bonus policy.

5.4 Deposit schemes are generally run by building societies.

- The main benefit is safety. But most investors will be better off investing in share-based schemes.

5.5 Unit trust and investment trust plans invest your contributions in pooled investment funds.

- Initial charges may be high, but ongoing charges may be lower.

5.6 Stakeholder pensions are personal schemes designed to be cheap and flexible.

5.7 Executive pension plans and self-invested personal pensions (SIPPs)

tend to have higher charges and generally appeal to higher earners. SIPPs allow greater investment choices. Executive pension schemes are classed by HM Revenue & Customs as company schemes.

6 Getting advice

Always shop around and compare investment performance and charges before you commit your money. Obtain professional advice.

Your employer may be willing to pay for advice. Pensions advice to any annual value of up to £150 can now be offered as a tax-free benefit, provided it is made available to all employees.

6.1 Many organisations sell personal pension plans, including unit trust companies, banks and building societies, life assurance companies and professional advisers.

- A company's agent or sales person will recommend plans from the company's own portfolio or that of partner providers', which they believe to be suitable. Independent financial advisers will search a variety of providers and recommend a plan which they believe to be suitable.
- Some will receive a commission if you buy from them, while others will charge a fee.
- Check with the Financial Services Authority that the company or adviser is regulated under the Financial Services Act (0845 606 1234 or www.fsa.gov.uk).

6.2 The adviser must complete a 'fact find' to ensure your needs are met.

- You will be asked questions about your income, investment aims, marital status and financial commitments.

6.3 The adviser must provide you with specific details about the recommended plan:

- An illustration (not guaranteed) of the value of your pension on retirement. This shows what might happen if your fund grew at 3, 5 or 7 per cent a year.
- An illustration of what those figures could mean in present day money, after allowing for inflation.
- Details of charges and how they will reduce investment performance, assuming a set rate of investment growth.
- How much the total charges would amount to over the full-term of the policy.
- How much commission the adviser earns.

Further help

There are other Directors' Briefing titles that can help you. These briefings are referred to in the text by name, such as **Company pension schemes** and **Stakeholder pensions**.

© Business Hotline Publications Ltd 2006. ISSN 1369-1996. All rights reserved. No part of this publication may be reproduced or transmitted without the written permission of the publisher. This publication is for general guidance only. The publisher, expert contributors and distributor disclaim all liability for any errors or omissions. Consult your local business support organisation or your professional adviser for help and advice.