Technical Connection

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THE DEFERRAL OF STATE PENSIONS

The terms for deferring state pensions now look overly generous

Back in April 2005, the basis for deferral of state pensions changed. Instead of $^1/_7$% increase for each week of deferral, this was raised to $^1/_5$% a week – equivalent to 10.4% a year (with no compounding, unfortunately). At the time base rate was 4.75%, a figure closely matched by the yield on short-dated gilts. That meant the deferral offer was attractive, but not a great deal.

A year later the option to defer state pensions in return for a lump sum was introduced. There is no limit to the deferral period but if deferral is chosen the whole of the state pension must be deferred. The lump sum is calculated on the basis that the pension payments not made are accumulated at a gross interest rate of base rate plus 2% per annum (i.e. 2.5% at present). The lump sum is fully taxable, but taxed at the individual's highest main rate of tax, not simply added to their income. (The main rates of tax are 20%, 40% and 50% for this purpose which excludes, for example, the 10% starting rate that can apply to savings income). This treatment means basic rate taxpayers can avoid a possible one year trip into the higher rate tax band when they draw their lump sum. In addition, the lump sum is not treated as part of total income for age allowance purposes.

We recently had cause to re-assess these deferral terms when an IFA asked us to undertake some example calculations. Our conclusions, based on the current fiscal environment and assuming the individual is in good health, are:

Deferral for a lump sum

This was not very appealing back in 2006 and remains so. The Government Actuary's Department originally calculated that deferral would be of financial benefit to the Treasury, which rather gives the game away. Finding more than a 2.5% gross return for instant access savings is currently relatively easy. So, assuming the individual expects to pay the same rate of tax in the future, the logical thing to do would be to draw the pension and use it to feed an appropriate savings account. This has the added benefit of avoiding some of the problems deferral can create, for example where a wife has entitlement both in her own right and via her husband's contributions and gains nothing from deferral.

There are, however, two obvious situations where lump sum deferral is preferable to the draw-and-save approach:

- Where the state pension causes a person to lose entitlement to all or part of their age allowance (either because their other income is already just over £24,000 or the addition of the state pension causes it to exceed £24,000) the deferral of the state pension can produce a useful tax saving that will more than compensate for the modest interest rate. For example, if £5,000 is taken out of the total income figure for age allowance purposes by pension deferral, then this could result in an increase of up to £2,500 in allowances and thus up to a £500 tax saving – effectively a 10% net return on the £5,000 taken out of the total income figure.

- For someone whose income will fall into a lower tax band at some point after state pension age, the "highest main rate" tax treatment described above will normally make lump sum deferral more attractive.

Deferral for an increased pension

This option now looks very appealing, particularly for shorter terms where the lack of compounding is of less importance. For example, using figures from the DWP's own guide, deferring £100 a week state pension for one year currently provides either:

- A taxable lump sum of £5,270; or

- An increase in taxable pension of £10.40 a week (£540.80 a year), possibly with a corresponding increase to any dependant's pension.

For a man who defers taking the state pension at age 65 then at age 66 that extra pension (on a single life basis) would cost about £13,200, while for a woman aged 61 the figure rises to over £17,300. It is worth noting too that for the basic state pension, a 'triple lock' now applies to increases, i.e. the greater of 2.5%, CPI and average earnings increases. In theory this should have prompted the DWP to worsen the deferral terms. For other state pensions, CPI sets the increase basis, which arguably would require an adjustment in the opposite direction.

COMMENT

Delaying the start of state pensions in return for increased pension payments at a later date now looks a generous deal. However, it will not suit everyone, such as somebody in ill health. Furthermore, single people need to be aware that their estate can only benefit from a maximum of three months' unpaid pension.

DRAWDOWN RATE AT ALL-TIME LOW

The drawdown interest rate for September 2011 of 3.25% is the lowest rate in the 16 year history of drawdown, although we have been here once before: the rate for April 2009 was also 3.25%. That reflected the dark days of March 2009, when equity markets were registering their post-credit crisis lows and there was a 'flight to quality', perceived at that time to be government bonds. At least back then the crisis meant that there were much higher corporate bond yields (6.23% for 15 year+ AA rated bonds in mid-March 2009) and hence higher annuity rates.

The September 2011 3.25% drawdown rate means that there are some substantial drops in maximum income levels being faced by those whose drawdown level was last set in September 2006. The underlying interest rate for September 2006 was 4.5% and the FTSE 100 at the start of the month stood at 5906.1. The table below shows the maximum drawdown rates in September 2006 and September 2011, for various ages. This demonstrates that the typical maximum drawdown rate has fallen by around 20%.

Age in 2006	Age in 2011	Max Draw Men		Max Draw Women	
		2006 %	2011 %	2006 %	2011 %
55	60	6.96	5.40	6.72	5.10
60	65	7.68	6.10	7.20	5.70
65	70	8.64	7.00	8.04	6.60
70	75	9.96	8.50	9.12	7.80

What does this mean in practice? Let's assume:

- Trustnet average balanced managed fund (40%-85% shares) past performance over the last five years;
- A man aged 60 in September 2006 with a fund of £500,000 after drawing his PCLS; and
- Maximum annually in advance withdrawals of £38,400 (7.68%) taken from September 2006.

By now the fund would be around £350,000, to which a maximum drawdown rate of 6.1% would apply. Thus the maximum annual withdrawal for the next three years would be £21,350, a reduction of nearly 45% from the previous level.

If the same individual had limited their yearly drawdown to £25,000 (5%), their fund now would be about 15% smaller than when they started. They would just be able to maintain their £25,000 withdrawals at review as the new limit would be a shade below £26,000.

COMMENT

The combination of falling yields, poorly performing markets and a revised HMRC/GAD rate basis will make drawdown reviews a painful exercise for some. The results illustrated above underline the dangers of high drawdown levels and reinforce the logic of the Treasury's decision to move from a ceiling of 120% to 100% of the HMRC/GAD rate.

FIXED PROTECTION ELECTION FORM ISSUED

HMRC has issued the new form (APSS227) necessary to elect for fixed protection, together with accompanying guidance notes. HMRC is adamant that it will not accept late elections and it must receive the completed form on or before Thursday 5 April 2012. Only paper elections will be accepted. If a form is incorrectly completed, HMRC will return it for amendment. If a form is returned after 5 April 2012, HMRC will allow four weeks for the revised form to be submitted. This presumably means four weeks from the date HMRC returns the form, although the guidance does not make this clear.

No certificates confirming fixed protection applies will be issued by HMRC prior to 12 October 2011 and HMRC has confirmed an individual must opt out within one month of being automatically enrolled in a scheme (e.g. NEST) if they are to retain fixed protection.

PENSION SCHEMES NEWSLETTER 48

HMRC has issued Pension Schemes Newsletter Number 48 which covers the following:-

- A brief summary of the recent changes as a result of the Finance Act 2011 and associated regulations.

- Confirmation that HMRC has already issued a significant number of pages of draft guidance associated with the Finance Act 2011 changes and that it will be updating the RPSM to reflect these changes as soon as possible.

- The procedure for electing for fixed protection.

- The scheme reporting requirements for flexible drawdown payments.

- The pension benefit reforms and changes to the Accounting for Tax (AFT) return. As part of the changes made by Finance Act 2011, the special lump sum death benefits tax charge was increased from 35% to 55% for deaths occurring on or after 6 April 2011; and a new income tax charge (the serious ill-health lump sum charge), at the rate of 55%, was introduced for payments made on or after age 75.

  Scheme administrators must account for each of these tax charges using the online AFT form.

HMRC is currently updating the online AFT form to reflect the new serious ill-health lump sum tax charge and the new rate of tax for the special lump sum death benefits charge; however the IT changes will not come into effect until April 2012.

In the interim, scheme administrators should use the existing question relating to the special lump sum death benefits charge to account for the tax due in respect of the special lump sum death benefits charge (for both the 35% rate and the 55% rate) and in respect of the serious ill-health lump sum charge.

REVISED ANNUAL ALLOWANCE GUIDANCE

HMRC has updated the draft guidance provided in respect of the annual allowance provisions after the changes in the Finance Act 2011 and associated regulations.

FALLING ANNUITY RATES

In the first week of August 2011 three big players in the annuity market – Aviva, Prudential and Legal & General – cut their annuity rates. As the tables below show, long-term bond yields have been falling, with about 0.4% off yields (as at 8 August 2011) since the start of July. As a rough rule of thumb each 1% yield fall equates to about £8 per mille (0.8%) off annuity rates.

Date	AA 15+ Corporate Bonds %	15+ Gilts %
8/8/2006	5.01	4.68
8/8/2007	5.72	4.60
8/8/2008	6.35	4.53
10/8/2009	5.82	4.26
9/8/2010	5.21	4.15
4/1/2011	5.42	4.22
1/4/2011	5.49	4.31
1/6/2011	5.23	4.04
1/7/2011	5.47	4.24
1/8/2011	5.19	3.93
8/8/2011	5.13	3.81

Source: Markit iBoxx

One point the table highlights is that the gap between corporate bond yields, which are more relevant for annuities, and gilt yields is once again widening – up from 1.18% at the start of April 2011 to 1.32% now. However, the move is much less dramatic than happened in 2007/08.

COMMENT

These are difficult times for retirement income seekers, but in fact rates are not that different from 12 months ago.

TAX ON GAINS MADE ON SALES OF PROPERTIES WORTH OVER £1 MILLION?

The Liberal Democrats are reported to be pushing for capital gains tax to be levied on gains made on the sale of principal private residences worth over £1 million after acknowledging they will lose the battle to retain the 50p highest rate of income tax. Vince Cable is reported to be the main proponent of this new tax as a kind of "son of mansion tax".

Earlier there was some talk of pressure to reduce the 50% additional rate to 45%. As we know nothing has happened on this yet.

Regardless of whether and when the 50% tax rate is abolished, and what (if anything) its replacement will be, advisers should keep to the front of mind the power of tax deferment strategies for those currently paying 50% tax.

CALL FOR THE REGULATION OF WILL WRITING

The Legal Services Panel, an eight person panel that investigates consumer legal issues on behalf of the Legal Services Board, has released its findings on its investigation into will writing.

Part of the investigation was a mystery shopping exercise. The mystery shoppers found one in five wills they looked at were not of an acceptable standard; and wills prepared by high street solicitors were just as likely to be as unsatisfactory as those from lay willwriters.

The conclusion the Panel has come to is that will writing ought to be regulated. The institute of Professional Willwriters is angling to be the official regulator if the Legal Services Board agrees.

The lack of professionalism in the drafting of wills is seen to have arisen from the rise in the number of non-legally trained willwriters who offer services at rates that professional willwriters cannot match.

The problem for individuals is that an incorrectly written will can have unforeseen consequences, both with regard to the destination of their estate and the amount of inheritance tax that may be payable. The meaning of a will can turn on one incorrectly placed word, or comma or full-stop. Clients should be directed to a qualified solicitor if they need a will written.

UPDATED ISA GUIDANCE NOTES

The ISA guidance notes for managers have been updated so that they now include guidance on the Junior ISA.

HMRC TARGETS DISHONEST AGENTS

HMRC has issued a discussion document entitled "Working with Tax Agents: Dishonest Conduct". The discussion document sets out HMRC's latest proposals and draft legislation. Key points include:

- The issue of dishonest conduct notices, with a right of appeal, where there is evidence a tax agent has dishonestly advised or assisted clients;
- Subject to approval by the First-tier Tax Tribunal, access to the working papers of dishonest tax agents once dishonest conduct has been determined;
- Where working papers are no longer in the power or possession of the tax agent, HMRC will be able to request these from a third party; and
- A civil penalty on the dishonest tax agent and a power allowing HMRC to publish details on the HMRC website where the agent does not make a full disclosure.

The consultation period for the discussion document runs to 16 September 2011.

COMMENT

This is just the latest in a series of attacks on what HMRC sees as tax evasion. Clients should try their best to ensure that anyone who works on their behalf in relation to tax affairs is honest. The liability for any unpaid tax will always fall on the taxpayer, not the agent.

INCOME TAX – TEMPORARY 50% RATE?

In the committee stage debates on the Finance (No.3) Bill David Gauke (Exchequer Secretary to the Treasury) said that there was considerable uncertainty about the "Behavioural impacts of the 50% additional rate, such as to what extent it would increase tax avoidance, to what extent it will cause people to leave and/or not come to the UK or even to retire earlier". He stressed (as the Chancellor had) that he saw the 50% rate as a temporary measure and that it could be "damaging" to the UK's competiveness were it to become a permanent feature of the UK tax system.

Confirmation of the intended temporary nature of the 50% rate is encouraging. But at the moment it is a real present danger to those affected by it. Evidence is that the harsher and more direct a tax is the more a client/taxpayer is willing to take action to avoid it.

For advisers with clients in this segment, a strong "50% tax-saving audit" approach could work wonders. This is especially so given that much of the research available in relation to adviser charging indicates that strong value is attached by consumers to tax planning and the financial benefits that can be secured through its successful execution.

Advisers should consider reminding "affected" clients of the opportunities to improve their tax/financial position through simple strategies such as

- Salary/dividend sacrifice
- Pension contributions
- Investing for growth
- Tax deferment through investment in UK/offshore bonds
- Avoiding tax on investment income through ISAs
- Maximising the use of exemptions and reliefs between spouses

to name just a few.

For example, merely ensuring that a non-working spouse with an "intact" personal income tax allowance is able to use it could save over £3,500 for a couple where the higher earner is a 50% taxpayer.

Further savings can be secured in the right circumstances by "reclaiming" the personal allowance ie. if income can be brought down below £100,000.

All the formalities to facilitate a transfer of income or source of business income should be considered so as to turn theory into practice. In relation to "spousal" shares in a company they must be ordinary, fully participating shares to avoid any "anti-avoidance/settlement" challenge.

NATIONAL MINIMUM WAGE - NEW LIMITS FROM 1 OCTOBER 2011

The national minimum wage (NMW) is the minimum amount defined by law that an employer must pay their workers. Rates are scheduled to rise from 1 October 2011 as follows:

- The adult ("main") rate rises from £5.93 per hour to £6.08 per hour for workers aged 21 years and over.

- The development rate rises from £4.92 to £4.98 per hour for workers aged 18 to 20 years inclusive.

- The rate for workers under age 18 who are no longer of compulsory school age rises from £3.64 to £3.68 per hour.

- The single apprentice minimum wage rate of £2.50 per hour rises to £2.60 per hour.

INCOME WITHDRAWAL RATE FOR SEPTEMBER 2011

The appropriate gilt yield, used to determine the 'relevant annuity rate' from HMRC's tables for an adult member commencing income withdrawals (or reaching an income withdrawal review date), in September 2011 is 3.25%.