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Pensions tax relief under threat again

Tax relief on pensions is likely to be more and more restricted in the future.

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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. Levels and bases of and reliefs from taxation are subject to change.

Forward guidance goes backwards

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

Imagine you were the Governor of the Bank of England or, even more powerful, Chairman of the US Federal Reserve. How would you convince everyone that interest rates are going to stay at current low levels for several years?

It is too dangerous just to say "I am fixing rates until 2016" because then you would become hostage to events over which you have no control (including the decisions of politicians). 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 on both sides of the Atlantic. 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. The latest (May-July) unemployment figure is 7.7%. The Bank gave itself 'wriggle room' by setting out three "kickouts" that could trigger an early change:

1. If the Bank were to decide that it was more likely than not, that inflation as measured by the consumer prices index (CPI) for the following 18-24 months would be 2.5% or more;
2. If medium-term inflation expectations would no longer remain "sufficiently well anchored"; and
3. If there would be a significant threat to financial stability related to the continued low rates.

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 bank rates could possibly rise around the end of 2014 / early 2015, 18 months earlier than the Bank had in mind.

It is a similar story across the Atlantic where during the summer, investors thought that they had been given forward guidance of the phased ending of QE (quantitative easing) by Ben Bernanke, the head of the US Federal Reserve, only to discover in September that no immediate adjustments were to be made. The markets were left wondering what would happen next and the uncertainty created some volatility in share prices.

For Messrs Carney and Bernanke, "forward guidance" has proved more difficult than expected. Both central bankers feel they need to keep interest rates low and to convince their audiences that this will happen. Both are concerned that an expectation of rising rates could damage economic recovery by discouraging investment, whether in business assets or new built residential property. But neither can give that cast iron "no change" guarantee.

For investors, the thrust of the bankers' guidance 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.

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.

Retirement income: How much is enough?

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. The two-thirds of earnings target was even built into pension tax legislation before disappearing with 'simplification' in 2006.

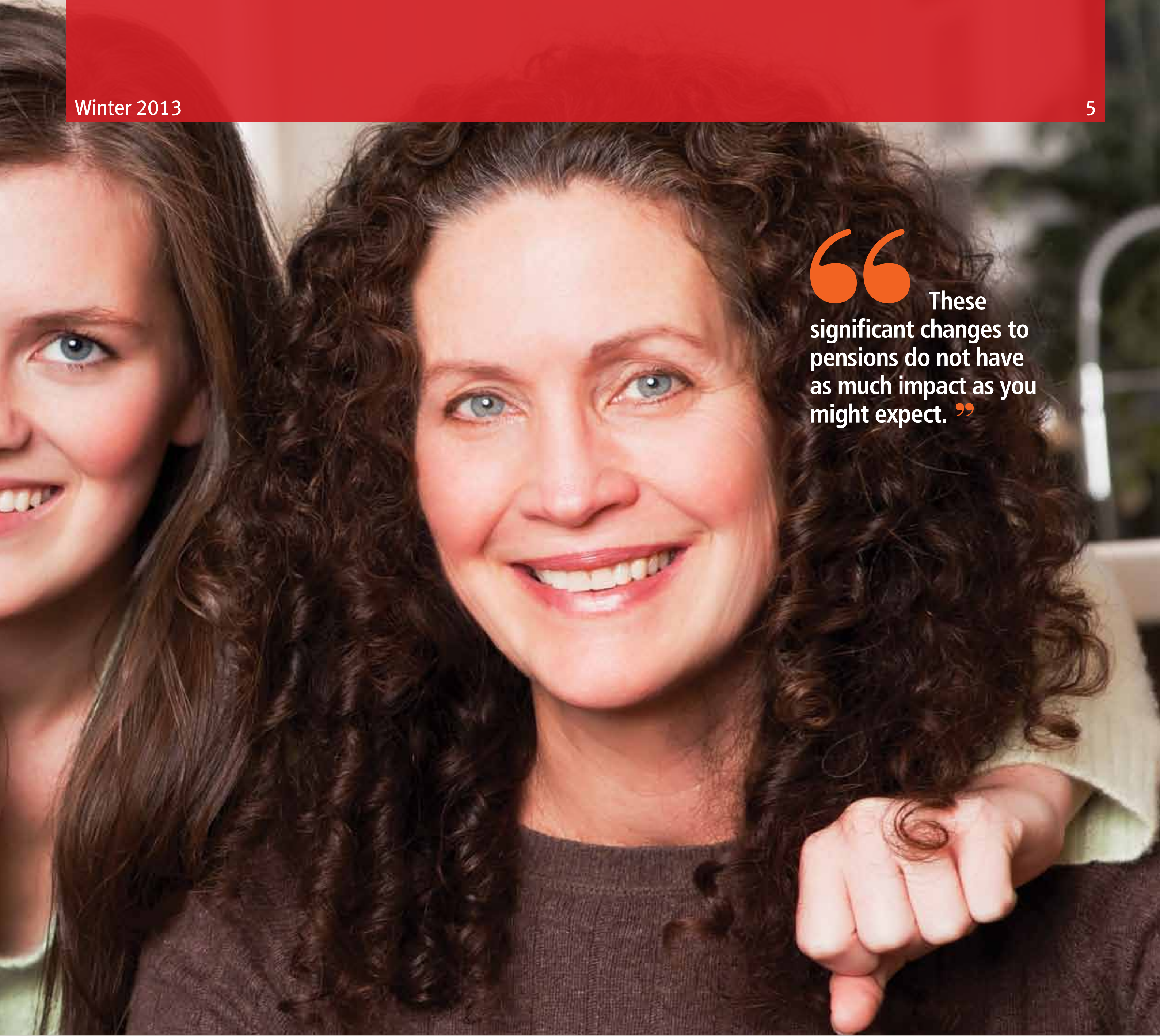
Two-thirds of earnings was an arbitrary figure, not least because it ignored important factors like the level of earnings, value of state pensions and the impact of tax and national insurance contributions.

These days there is a more sophisticated analysis 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, rather than in the year immediately before retirement. The result is the target income replacement rates table shown opposite.

Ironically, the table does contain a central two-thirds figure – well 67% – in the area of median UK earnings, but there are substantial variations either side. The earnings bands are not neatly round numbers because the DWP has reworked figures produced by the Pensions Commission in 2004, increasing them in line with earnings since then.

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.

Inadequate income

These significant changes to pensions do not have as much impact as you might expect. The DWP says that the reforms will "reduce the number of people facing inadequate retirement incomes by 1 million", but concedes that there will still be "an estimated 12.2 million people facing inadequate retirement incomes." Of that 12.2 million, 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."

This highlighted comment reveals one of the hidden effects of the pension changes the Government is making. The single-tier pension will remove the existing earnings-related element of the state pension, which currently covers earnings up to £40,040. While contributions under the automatic enrolment regime are earnings-related, it will take another five years before they reach their full level. Even then, in current terms they will only cover earnings up to £41,450, the threshold for higher rate tax.

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 says (in bold) "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. Let us know if you wish to review your pension planning.

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Annuities – going through the fine print

A new annuity table demonstrates the huge variation in rates between insurance companies and how it pays to shop around.

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 you 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.

An annuity is the most straightforward way in which you can convert your pension fund into a retirement income and has the virtue of sidestepping the investment risks associated with nearly all other options. In many instances, an annuity will be the only sensible choice available. However, the annuity market is seen in some quarters as in need of an overhaul because the way in which it operates.

	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	£1,350.57
Best/Worst Ratio	£126.4%	147.9%

The Financial Conduct Authority is in the middle of a "thematic review" of the annuity market and the Pensions Minister, Steve Webb, recently pledged to establish an "annuities task force" to examine both annuities and their alternatives.

The Association of British Insurers (ABI) – effectively the annuity providers' trade body – began publishing specimen annuity rates on its website. 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). On the face of it, that makes the ABI offering seem less than helpful, but it has one important feature which other annuity tables lack. The ABI has obtained annuity rates from those of its members who choose not to compete in the open annuity market, but instead only sell annuities to their own pension policyholders (in some cases this is because those companies are closed to new business). In some cases this is because those companies are closed to new business.

The ABI tables thus capture many annuity providers that do not appear in other league tables. As a result the ABI has, perhaps unwittingly, highlighted the large disparity in annuity rates on offer. The brief table below gives an indication of the differences in annual income for a 65 year old Manchester resident with £18,000 to invest. That may seem a relatively low amount, but last year the average annuity purchase price was around £25,000.

Even this rate table does not tell the whole story. Some providers chose not to quote for the severely impaired profile because they did not offer underwritten annuities. At worst, that could mean that if you are seriously ill, you would be offered standard rates, with your health condition ignored.

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.

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.

> "An annuity is the most straightforward way to convert your pension fund into a retirement income"

Keeping up with your financial protection needs

At least every two or three years, you should take a good look at your life assurance and health insurance protection to see if it still provides what you need.

Prices have risen about 12% in the last three years according to the retail prices index. If you have not reviewed cover since the start of this decade, that 12% figure should be enough to prompt a review of your cover levels.

Of course some areas of expenditure – the costs of higher education for example – have gone up significantly in the last three years.

When you are considering your financial protection needs, 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.

How much cover do I need?

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.

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.

You also need to make sure you are covered in case you have a serious illness or accident that leaves you (or your partner) unable to work. This type of cover, income protection, is one that you should have even if you are on your own and do not have any financial dependents.

Income protection now comes in a variety of guises and, as with life cover, normally the wisest approach is to seek expert advice on the appropriate cover for your circumstances. Do not think that the State will supply an answer. Employment and Support Allowance (ESA), which replaced Incapacity Benefit five years ago, is subject to notoriously strict work-related assessments. The current basic ESA rate for the first 13 weeks is £71.70 a week for a single person aged 25 or over and £112.55 for a couple.

31 January reminder

If you have to provide HMRC with a 2012/13 tax return and did not file a paper version by 31 October, you must file online by Friday 31 January 2014. Even if you are only a day late, you will be subject to a £100 flat penalty, which applies regardless of the amount of tax you owe HMRC (or vice versa). As tax papers have a strange tendency to go missing when you need them, it is a good idea to start the information-gathering stage well before that end of January deadline.

The Financial Conduct Authority does not regulate tax advice. Tax laws and levels, bases of and reliefs from taxation may be subject to change and their value depends on your individual circumstances.

Is it time to buy emerging markets funds?

Recent falls in many emerging country stock markets have prompted some professional investors and commentators to suggest that this could be a good time to invest in this sector.

Recent falls in many emerging country stock markets have prompted some professional investors and commentators to suggest that this could be a good time to invest in this sector. So how should you be considering investment in these historically volatile markets, with all their pitfalls and possibilities?

China has grown phenomenally in the last three decades. But recently there has been a much bumpier ride as the economic engine has slowed down sharply from the heady annual growth rates of 10% and more. Chinese share prices have reacted accordingly and are now less than half their 2007 peak. The picture is mixed across other Far Eastern stock markets, although volatility has been a factor for all in 2013.

India has also experienced rapid economic and stock market growth, but Indian shares have also suffered considerable volatility in recent months. The story is similar in the emerging markets of Latin America. All of which could present a buying opportunity for investors or possibly a warning of worse to come. Of course, it could be both.

There are good reasons to be wary about investing in emerging markets. Despite reforms, they tend to be less well regulated; some, like China, effectively discriminate against outsiders; there is much political and social uncertainty and the economies themselves are often subject to violent stops and starts. But emerging markets – especially the leading ones in the BRIC economies of Brazil, Russia, India and China – have in the recent past demonstrated economic growth rates that Westerners can but dream of for their own economies.

So there should be room for emerging market funds in your portfolio, provided that you can watch violent fluctuations in the value without great anxiety. You should be able to take at least a ten year view and hold a well-diversified range of assets, allowing you to absorb losses if necessary.

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. Investing in shares should be regarded as a long-term investment and should fit in with your overall attitude to risk and financial circumstances.

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