KENNEDY BLACK
WEALTH MANAGEMENT

QUARTERLY PRIVATE CLIENT NEWSLETTER ISSUE 18: JUNE 2014

Welcome to the latest edition of Kennedy Black Wealth Management's Private Client Newsletter. This edition focuses solely on pensions, now that the dust has settled on some of the far-reaching changes announced in February's Budget.

We have sought to outline the changes – what they are, why they are significant and what the potential ramifications might be.

Please note that a lot of the changes we discuss are still in a formal Consultation Phase. A lot of what we discuss is based on our understanding of the initial proposals and subject to political U-turn. We would strongly encourage anyone thinking about their retirement options (even many years ahead) to get in touch immediately to discuss your particular circumstances.

The Budget 2014

It has been a couple of months since the Budget. George Osborne made significant headlines with some of the most far-reaching pension changes for many years.

The financial services industry continues to debate the whats, whys, hows and what-ifs. But we thought it might be helpful to start with a jargon-free guide to the proposals and the impact they may have.

D.C. Pensions 101

Not everyone gets as excited about pensions as we do, so we shall start with a very brief overview of how pensions currently work.

The new rules only relate to Defined Contribution (DC) pensions, so that's what we focus on here.

A DC pension is one where you and/or your employer contributes and you invest the money, typically in a range of funds. Contributions attract relief from income tax. Growth is tax-free and access is restricted until at least age 55. At retirement, 25% of the pot can be drawn as a tax-free lump sum and, under current rules, at least 75% of the pot must be used to provide some sort of (taxable) income in retirement.

The alternative to DC, which we won't bother explaining here, is a Defined Benefit pension (also known as 'final salary').

When you reach retirement there are a number of options available with a DC pension, of which the most well-known is an annuity. In simple terms, an annuity is an 'income for life.' In exchange for a pot of money – typically the pension assets built up to that point – an insurance company will promise to pay an income to the pensioner for the rest of his/her life based on his/her life expectancy.

The benefit of an annuity is that there is absolute certainty that the income will never run out, no matter how long the recipient lives. This benefits the taxpayer, since it reduces the need to rely on State Benefits once the money has run out.

Despite what you might read in the press, there has been no absolute obligation to buy an annuity since 2006. One alternative to an annuity is 'Drawdown'. In Drawdown, the pension money remains invested and the pensioner can draw an income directly from the pot. While there is potential for some investment performance, there is also the risk that the pot could run out. There are therefore limits on how much income an individual can draw from a pension, more or less linked to an equivalent annuity rate.

The proposed changes

In the Budget, George Osborne has effectively removed all the restrictions as to how one can draw an income from a Defined Contribution pension. In short, the whole pot could be withdrawn on day one.

This may sound attractive. But there is a downside: tax. Pension income is taxable. While the first 25% of the withdrawal will be tax-free, the rest will attract income tax at the retiree's marginal rate (i.e. higher-rate taxpayers will pay 40% on the withdrawal).

For example, on a pot of £300,000, a top (45%) taxpayer would pay £101,250 in tax and end up with just £198,750 in the bank – if the whole pot is taken in one tax year.

The government, in all its worldly generosity, is anticipating that people won't be able to resist the lure of all that cash and will simply pay more tax, to the tune of an extra £3bn over 4 years (source: HM Treasury).

And therein lies the challenge. It might be tempting to withdraw the full pot and buy a Lamborghini (as Steve Webb, the Pensions Minister, suggested). But if that is your aim, you need to think *very* long and hard about what you plan to do next. Not only can careful planning reduce the amount of tax payable, but an objective opinion from an informed third party will be absolutely critical to prevent poverty in old age.

We have commented in previous editions of this newsletter about the woeful level of retirement provisioning by Generations X and Y (i.e. anyone born since the mid-1960s). Pensioner poverty is a real risk unless people take greater personal responsibility for their own retirement.

Get in touch if you want to be among the responsible few.

Possible Impact

These are among the most dramatic changes to pensions in a generation. Yet it is important to consider areas where there might be unintended consequences. Having given this some thought, we think the following deserve further consideration:

Offshore Pensions
One area this may have an immediate impact is the market for offshore pensions.
QROPS ('Qualified Recognised Overseas Pension Schemes') can be very tax-efficient pensions for people looking to retire abroad (e.g. foreign expats working in the UK, or UK citizens looking to retire somewhere warm). QROPs offer a variety of benefits, but we believe it unlikely that unrestricted access will be offered in the same way as in the UK, for fear of abuse. The relative attractiveness of QROPS seems to have been reduced.

Divorce
Unrestricted access (albeit with a big tax bill) will have impact in the world of divorce, where 'pension sharing' arrangements have been complicated affairs. With unrestricted access, will it be possible for one party in a divorce to enforce a full withdrawal? Could divorce be undertaken 'tactically' – as part of tax-efficient retirement planning?

Bankruptcy and scams
In similar fashion to divorce, what happens to someone going through insolvency proceedings? Will creditors be able to claim the pension fund in its entirety?

Furthermore, the government has been keen to clamp down on unauthorised 'Pension Liberation' schemes. Opening pensions up to full withdrawals should in theory deter this activity. However, surely it opens the door to other types of scams, now that pension assets will be available to the nefarious and wicked?

Tax-free cash
We believe that the days of 25% tax-free cash are numbered. Under the new rules, we think it will be easier politically for the Treasury to reduce or remove this benefit.

Tax inefficiency
If you contribute to a pension as a basic-rate taxpayer, you will benefit from 20% income tax relief. Yet, if you end up withdrawing your pension in one go, incurring 40% income tax in the process, your pension is a tax-*inefficient* vehicle. It would have been more tax-efficient to have used an ISA.

Much is likely to change in the next few months so we would urge you to get in touch if you would like to work out how things might affect you personally. We would be delighted to give you a quick no-obligation opinion as to your circumstances. We'll even throw in a coffee.

Irrational behaviour #8:

"Availability heuristic"

The brain has a tendency to rely on immediate examples that come to mind. If something can be recalled, the mind presumes it is probably important. However, this can reduce one's ability to judge frequency and probability of events.

The classic test of this (courtesy of Kahneman and Tversky) is to ask whether you think there are more words in the English language with the letter *K* as its first or third letter?

While you will find it much easier to think of words beginning with *K*, you might be surprised to find out that there are three times as many words with *K* as the third letter.

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