Pensions & Retirement Planning: Accumulation Phase
Part 4: Accumulation phase Planning

The milestones are to understand:

- The main investment strategies and considerations in the accumulation phase.
- The circumstances when pension plans should be reviewed.
- The options for dealing with pensions on divorce
- The main alternatives to pensions for retirement planning

Pension Planning Strategy

If a pension product is selected there are two key considerations:

- How much should the individual contribute?
- Where should the fund be invested

The first issue is likely to be limited by affordability. The adviser should try and establish the income that the client is likely to need at retirement. This can be difficult particularly for someone in their 20's or 30's.

In the past pension products were structured like an endowment with a set retirement date and regular payments that couldn't be varied. Today products are much more flexible allowing contributions to be varied, suspended and lump sums added. They will have a planned retirement date but the member can take benefits at any time once the minimum pension age has been reached.

Using this flexibility, a better approach for the client and the adviser may be to focus on building up as big a fund as possible viewing it as a continuous process rather than a one off event. Throughout the client's working life constant adjustments need to be made to ensure the plan is on track and to cope with unexpected events such as a change of job, redundancy or divorce. Then as retirement approaches advisers should check that everything is ready for a smooth transition to converting the fund into income.

Investment considerations

Since a money purchase arrangement is simply tax wrapper the normal investment practices should apply. That is a diversification of different asset classes with the aim of achieving negative correlation, periodic reviews and rebalancing when required.

The client's attitude to risk and capacity of loss must be taken into consideration. The traditional approach was to invest mainly in equities when the client is young and reduce the risk by switching to Bonds as retirement approaches. This could be done automatically using a **Lifestyle Fund** but this has disadvantages.

- Switching to Bonds and cash close to retirement makes sense if an annuity is to be purchased but may not be appropriate if benefits are to be taken flexibly.
- Under a life styling approach funds will be switched usually five years before planned retirement age but if plans change and retirement is earlier or later this will not be appropriate.

Periodic Reviews

Once a pension plan is started it needs to be reviewed on a regular basis and probably at least annually. The main points discussion should be:

- Fund performance should be monitored to ensure benchmarks are being met and rebalanced if appropriate
- Review client's attitude to risk and capacity for loss.
- The nomination of the death benefits should also be reviewed to ensure that they represent the current situation and wishes of the member.
- Any change in taxation or legislation.

There are certain events that will require a special review:

- Divorce.
- A change of job as a decision will need to be taken on what to do with the benefits in the old scheme and assess the pension available from the new employer.
- A change in terms of the member's occupational schemes
- A significant increase or decrease in income will also mean some adjustments may be necessary.
- Redundancy.
- Any inheritances or windfalls may offer the potential of a significant one off payment.
- Marriage, birth of a child.
- Serious illness

Pensions and divorce

A pension is considered a marital asset in the event of divorce. If both parties have roughly the same pension rights, there shouldn't be any issues. However, if one party has a much better pension than the other it will become part of the divorce negotiation.

There are three ways of dealing with a pension in a divorce:

- Offsetting
- Earmarking
- Splitting

Mr and Mrs Smith are getting divorced. He is a member of a scheme with good rights whereas hi swife has no pension. They have decided to use **offsetting.**

Mr Smith will keep his pension but will have to offer assets of similar value, possibly the marital home to her.

The benefits are:

- It is a clean break, they don't need to keep in contact with each other after the divorce.
- It is simple as it is an agreement between themselves and does not need a court order.

On the other hand Mrs Smith doesn't have a pension

Mr and Mrs Brown are getting divorced. She has much better pension rights than her husband. They have decided to use **earmarking**.

Mrs Brown might promise to pay part of her pension to her ex-husband when she takes her pension but this would be unenforceable.

Instead they will have to get a court order served on her scheme that compels it to pay a percentage of the pension to her ex-husband. This means that he will get a pension but there are serious drawbacks:

- It isn't a clean break
- The pension to her former husband can only be paid when she takes the pension. She might be vindictive and delay taking the pension or invest it in a very poor performing fund.
- Even if the split is amicable there could be issues if she is younger than him. She can't access the pension until minimum pension age when he might be in his late 60's.
- It is not tax efficient since it would be taxed at her rate which might be higher than his.
- If she dies before taking her pension, he may not receive anything although the court order may give a percentage of any survivor pension.
- Some orders may have a provision that it will come to an end if, in this case, Mr Brown remarries.

Mr and Mrs Jones are getting divorced and decided to use **pension sharing.** If Mr Jones has the better pension rights he can't instruct his scheme to transfer part of his fund to her as this would be an unauthorised payment.

Instead a court order must be served on the scheme forcing them to transfer a part of the fund to her. The result is that his pension fund will fall and she has a sum of money that she can invest in a pension of her choice.

It is advantageous to her as she will get a pension, she can choose where to invest it and decide when and how to take it.

The transfer is not classed as input so does not impact on her Annual Allowance. It will though count in calculating any Lifetime Allowance Charge.

Pension sharing is fairly simple with a money purchase arrangement but is more complex with a final salary pension. This will be looked at in the defined benefit section

Is a pension always the best option?

There is one situation when individuals should always take out a pension and that is when an employer offers a scheme or arrangement. Declining to join is effectively giving up a pay rise. Now that auto-enrolment is complete most employees will have access to a pension arrangement to which the employer must contribute.

The potential problem is that just making minimum contributions could give a false sense of security with many employees believing that their post work income has been sorted only to get a nasty shock when they stop work.

The self-employed do not benefit from auto-enrolment so must make a conscious decision to take out and contribute to a pension. The first issue for them and employees who wish to increase their retirement savings is whether a pension is the best option?

Pensions have had an undeserved reputation for inflexibility, poor performance and expensive charges. The Osborne reforms have removed many objections as to inflexibility. Competition has driven down charges and are often no different to other collective investments.

Whilst every individual's circumstances are different the following will serve as a basic strategy for most cases:

- If there is a work based pension join it.
- If the scheme offers the facility to increase contributions that will be matched by the employer this should be used rather than making an outside arrangement.
- If the client does not wish to increase their pension contributions, other tax privileged investments should be used

- Pension and non-pension investments should not be considered either/or choices but as complementary to each other.

It is not practical for most employees to get their employer to increase the employer contribution. However, both employee and employer may benefit from using salary sacrifice.

Salary sacrifice

Salary sacrifice is where the employee agrees to a reduction in salary or a bonus in return for the employer paying all or part of this this into the employee's pension.

From a tax viewpoint it is neutral. For example, if a basic rate tax payer received a £5,000 bonus they would receive £4,000 net of tax so if they put this back into a Personal Pension it would be grossed up to £5,000.

The savings come from the fact there is a reduction in National Insurance. If the bonus were taken as cash the employee would pay £600. Moreover, the employer would have to pay £690 which they don't on an employer pension contribution. Ideally the employee will be able to persuade the employer to put all or part of this saving into the pension. Someone who is a higher rate would only save 2% on their own contribution but the employer's NIC would remain the same.

All salary sacrifice arrangements have to be approved by HMRC but they will only do this once it is set up.

Salary sacrifice arrangements set up after July 8 2015 cannot be used to reduce the member's Threshold Income for the Tapered Annual Allowance.

Alternatives to pensions

Following our basic strategy tax privileged products should be used if the client does not wish to make or is prohibited from making further pension contributions. The main products to consider are:

- Individual Savings Accounts (ISA)
- VCT, EIS & SEIS

"Standard" ISA

An ISA and a Pension are mirror images of each other. Each has three stages as far as tax is concerned, contributions, investment and benefits.

A pension is tax exempt in the first two phases but benefits are taxed. This is described as EET.

An ISA is taxed on contributions but the final two phases are exempt which can be described as TEE.

There are other differences in the contribution phase

- An employer can contribute to a pension but not to an ISA.
- The contribution level to an ISA is fixed so if NRE is higher than £20,000 more can be put into a pension but if NRE is lower than £20,000, more can be contributed to an ISA.
- Unused pension contributions to a pension from previous years can be carried forward but an ISA works on a "use it or lose it" basis.

Individuals at the start of their working life who anticipate becoming a higher rate tax payer may benefit from contributing to an ISA whilst they are basic rate tax payers and transferring the funds to a pension when they become higher rate tax payers. This approach should be tempered by the possibility that higher rate tax relief on pensions may be restricted in the future.

In the investment phase, both are taxed in the same way but using a SIPP may offer a potentially wider range of assets than an ISA.

Advocates of the ISA have argued that it is a better product when it comes to taking benefits. There are no restrictions as to when or how benefits are taken and they are totally tax free. The fact that benefits can be taken at any time is something of a double edged sword if an ISA is being used primarily to fund retirement. The temptation to dip into it could be hard to resist whereas a pension cannot be touched until the member is 55.

The Osborne reforms mean that there is little restriction as to how benefits are taken from a pension although anything in excess of the PCLS will be subject to tax.

One issue often overlooked is that an ISA will always from part of the deceased's estate so could increase the IHT liability. Uncrystallised pension funds are exempt from IHT.

There is also the **Lifetime ISA** or **LISA** which is partly designed to provide a tax free income or capital after the investor turns 60.

Lifetime ISA (LISA)

This is designed to assist individuals who wish to:

- Purchase a **first** home
- Make provision for later life

A LISA has some common features with all other ISAs:

- It can only be in a single name.
- The "one provider per tax year" still applies although transfers can be made from one provider to another.
- Contributions are on a "use it or lose it" basis, there is no carry forward of unused allowances.
- It can hold cash, gilts and bonds, shares and collective investments such as unit trusts and OEICS
- There is no tax relief on the subscription.
- Benefits are tax free
- It cannot be written in trust and will always form part of the deceased's estate

The key differences on contributions are:

- Maximum annual subscription is £4,000 per tax year. This forms part of the overall £20,000 ISA allowance.
- It can only be opened by individuals aged between 18 and 40.
- Contributions can continue until the investor is 50.
- The Government will add a 25% bonus to each contribution. This means that someone contributing the maximum £4,000 will receive £1,000 in bonus giving a total investment of £5,000 which is the equivalent of basic tax relief.

The key differences in taking benefits are:

- Whilst a LISA can be encashed at any time there will be a 25% penalty on withdrawal unless:
- The withdrawal is used to help purchase a property up to a price of £450,000 for a **first time buyer**
- The withdrawal takes place after the investor's **60th birthday**
- The investor is terminally ill.

The exit charge is very severe as it is made on any investment growth as well as the original bonus.

Phil contributed £4,000 to a LISA for 10 years. At that point it had a value of £70,000. He then is forced to make a full encashment so receives £52,500 (£70,000 less £17,500).

The key differences between a "standard" ISA, a LISA and a PP/SIPP for retirement planning can be summarised as follows:

	"Standard" ISA	LISA	PP/SIPP
Eligibility	UK resident, no upper age limit	UK resident 18-40	UK resident, maximum age 75
Contributions	£20,000 per tax year	£4,000 per tax year which forms part of the overall £20,000 limit	100% of NRE Annual allowance £40,000 but could be subject to TAA
Government top up	None	25% of contribution up to a maximum of £1,000	Individual contributions get income tax relief at marginal rate
Minimum age to take benefits	None	Any time if used to purchase a first home, otherwise 60.	55 unless member qualifies for ill health pension or serious ill health lump sum
Taxation of benefits	Always tax free	Tax free if used for first house purchase or after 60. Anything outside these will result in a 25% tax charge	PCLS of 25% of fund, other withdrawals taxed as non-savings income
IHT	Always part of estate	Always part of the estate	Uncrystallised funds together with FAD funds are outside the estate

Making a choice

This should never be an either/or decision. Each product has different advantages and disadvantages. For most individuals a mix of pension an ISA will be the most appropriate solution. The factors that will influence that decision are:

- Eligibility
- Tax efficiency
- Accessibility

Eligibility

- The only requirement to take out a "standard" ISA is to be a UK tax resident. There is no upper age limit.
- Anyone over 40 cannot take out a LISA.
- Anyone over 75 cannot get tax relief on a pension contribution.
- Anyone who has enhanced or fixed protection cannot contribute to a pension

Tax efficiency

The basic difference between an ISA and a pension is contributions to an ISA come from taxed income but benefits are tax free whereas contributions to a pension are tax relievable but apart from the PCLS benefits are taxable. However for a basic rate tax payer a LISA is an EEE investment, there is no tax at either contribution, investment or benefit stage.

How this works out in practice can be seen by calculating the contribution required to produce £1,000 of capital

You would need to invest £1,000 is a standard ISA to produce £1,000 You would need to invest £800 into a LISA to produce £1,000

Those figures are the same regardless of the individual's tax situation. The figures for a pension will depend on the tax status when contributions are made and benefits are taken.

Accessibility

- Withdrawals from a standard ISA can be made at any time.
- Apart from ill health, benefits cannot be taken from a pension until 55.
- Benefits from a LISA can be withdrawn before 60 but unless this is to finance a first house purchase there will be a penalty of 25%

VCT/EIS/SEIS

These have been advocated as alternatives to pensions particularly for those prohibited from having further pension input. As they are used to provide capital for start-up and new businesses, they are high risk so the client must have an appropriate risk profile. There is also an argument that pensions and ISA contributions should be maximised before these are considered.

- The tax relief is 30% for VCT and EIS and 50% for SEIS.
- In all cases tax relief is given by a reduction in the investor's income tax liability but only to the extent of their tax liability
- The tax relief is only given on new issues. Purchases in the secondary market do not get any tax relief.

- The tax relief is clawed back if the investment is sold within three years for a EIS or SEIS and five years for a VCT.

The final two alternatives to are buy to let property and an individual's business.

Buy to let v Pension

Buy to let investment has grown significantly in recent years and can be an attractive alternative. It is a way of securing an increasing income and capital

Investing and managing a property portfolio is time consuming and expensive. It can be out sourced to a managing agent which will reduce the return. Any void periods will mean a loss of income and property is an illiquid asset.

When the property is sold it will be subject to CGT which from 16/17 is charged at a higher rate than other assets.

On the investor's death, the properties will be part of their estate whereas a pension fund will be outside of it.

A further disadvantage is that mortgage interest is not allowed as an expense against rental income.

A Business v Pension

Many self-employed or directors take the view that "my business is my pension" on the basis that at retirement the business will be sold and that will fund their income. This also has disadvantages. It lacks diversification since if the business fails both their current and post work livelihood will be lost. Economic conditions at retirement may mean it is difficult to sell or to get as high a price as might have been expected. The sale will also be subject to CGT although currently entrepreneur's relief could be used bringing the effective rate down to 10%.

Finally, are there occasions when it could be argued that a pension should be avoided? The most common situation is where someone has pension assets above the current lifetime allowance or is likely to exceed it at retirement.

That concludes this part so you should now understand:

- The main investment strategies and considerations in the accumulation phase.
- The circumstances when pension plans should be reviewed.
- The options for dealing with pensions on divorce
- The main alternatives to pensions for retirement planning

It also concludes the accumulation phase and we will now move on to taking the benefits.