

At last! Some good news on pensions

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From 2006, you will no longer be forced to buy an annuity at 75, and you can leave your pension fund to your heirs. Emma Simon reports on a pensions revolution

New rules due to come into force in April 2006 will mean that the over-75s will no longer have to buy an annuity with all their pension savings. In addition, their families will be able to inherit any remaining pension assets tax-free if they die before the money has run out.

Under the new rules, investors who choose to keep the money invested will have to set up an alternatively secured pension (ASP), a type of income drawdown plan. While the ASP will pay a smaller maximum pension than a conventional annuity, any money remaining in the fund can be inherited tax-free.

The Conservative Party and various lobby groups have been trying for years to get the Government to change the annuity rules, which currently compel everyone in a money-purchase pension scheme to buy an annuity by their 75th birthday. The advantage of annuities is that they pay a guaranteed income for life. The disadvantage is that any surplus funds revert to the annuity provider on death, and are used to help pay the pensions of those who live beyond their expected life span.

Many elderly investors resent the idea of losing their hard-earned pension savings to an insurance company if they die early, rather than being able to leave it to heirs.

The effective abolition of the "age 75" rule was achieved by a small Christian group, the Plymouth Brethren, which objected to annuities on moral grounds, arguing they were a form of gambling that profited from another's death.

To much amazement, the Government has taken these comments on board, and the change will be introduced in the latest Finance Bill, due to get royal assent in July.

The new rules will limit the maximum income from an ASP to 70 per cent of the best available annuity rate available for a 75-year-old, but there will be no requirement to take any income at all if the pensioner can get by on other savings.

The 70 per cent limit means that ASPs will clearly be unsuitable for people who need to derive the largest possible income from their pension pot. It also means pensioners are taking on more risk. If investment returns are below expectations, the income will suffer.

There is also the risk that the fund will be too small to provide an adequate income for life, leaving investors to fall back on means-tested state benefits. Although the rules do not specify any minimum fund size for an ASP, it is likely that most providers will only offer this option to consumers who have minimum pension - probably of about £100,000. If their fund falls below this level at any point they may advise them to transfer the remaining funds into an annuity.

However, for those with larger pension pots, an alternative income stream, or more than one pension, ASPs provide an effective means of bequeathing pension assets while also side-stepping inheritance tax (IHT).

Under the ASP rules, when the pensioner dies, the remaining fund must be used to provide a retirement income for a surviving spouse or dependent children, either from a conventional annuity or directly from an ASP. Children are classed as "dependent" if they are under 18, or under 23 if in full-time education.

If there are no dependents, the funds can be used for the benefit of other members of the scheme. In other words, rather than surplus funds being swallowed up by an insurance company, it will be possible to pass them on to named "members" of the same scheme, with no tax charge.

John Lawson, the senior technical manager at Standard Life, says: "This opens the door for pension wealth to cascade down the generations tax-free. Provided the assets remain within the pension scheme, there will be no income tax, capital gains tax or IHT to pay. These funds can be used to boost pension provision for your children and grandchildren."

Tom McPhail of Hargreaves Lansdown, the financial adviser, adds: "I can see this becoming an important tax-planning tool for more affluent individuals. But anyone with a reasonable pension fund, a family and a desire to avoid IHT could benefit."

Insurers such as Standard Life are likely to offer an ASP as an option on their personal pension schemes, Lawson says. So long as family members have their pension with the same insurer, they will be free to nominate which members they wish to benefit.

Similarly, if parents and children have Sipp (self-invested personal pensions) run by the same company, funds could be transferred



Hear ye! Hear ye! A pensions revolution is underway

into the child's pension pot on the death of a parent. Families could also set up an SSAS (small self-administered scheme), a pension used by small businesses. This would enable family members to pool funds to buy assets as well as ensure surpluses are shared within the family.

"The new pension regulations open up a number of opportunities for investors," Lawson says. Not only can they pass on assets to heirs; they will also be able to hold a wider range of assets, such as residential property, in their funds.

This means families could sell any property they own to the scheme, thus releasing cash while maintaining ownership of the home, albeit via a pension fund, and protecting the asset from any inheritance tax liability. He adds: "Of course, if a significant amount of money is released, this could still be subject to IHT. But there are far more ways of mitigating IHT on a cash lump sum than on a property."

The rules will also allow families to club together to buy a holiday home with their fund. From 2006, people will be able to contribute to more than one pension scheme at a time, provided the total value of these plans does not exceed the lifetime limit of £1.5m. This allows families to gain tax relief on buying a property which they could pass on to the next generation without paying IHT. But they could still keep their main pension arrangements separate, should they wish.

Lawson adds: "This will be an extremely tax-efficient way of buying a second property, even if people still opt for the security of buying an annuity with their main pension."

Andy Bell, managing director of A J Bell, the Sipp provider, gives a word of warning, however. Ruth Kelly, the economic secretary to the Treasury, has made it clear that the Government does not want these new rules to be "abused" by those looking to mitigate tax bills.

"The Government doesn't understand how attractive these new rules will be for many higher-net-worth individuals," he says. By setting the maximum income well below that payable from an annuity the Government is hoping to deter too many people from taking this route, he says.

"What they don't seem to grasp is that, for many people at this age, capital preservation is more important than maximising their income. These new rules will encourage them to do just that."

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