Beware the government's pension grab

By James Ferguson 27/03/2014

Relaxed about the pension lifetime allowance and its implications for your retirement planning? Then it's time for a wake-up call, says James Ferguson.

Chancellor George Osborne has enjoyed an unusual amount of adulation in the days since last week's Budget speech. He has been praised for increasing the amount of money that can be saved in individual savings accounts (Isas), and for making pensions far more flexible.

I'd agree that all of these changes are good individually, but there's one crucial aspect of the pensions regime that Osborne did nothing to change in his latest Budget speech. It's a sting in the tail that makes pensions potentially far less attractive as a savings vehicle, even for relatively young savers. I'm talking about the pension lifetime allowance (LTA).

From 6 April, Osborne will cut the LTA from £1.5m to £1.25m. That's a limit on the total amount of money allowed in your pension pot, not on the contributions you can make. If you breach the LTA, you'll be liable for a truly brutal 55% tax on the excess. I'll get to the details shortly.

But if you think you can turn the page and ignore this, think again. It may appear to apply solely to the well off (a £1.25m pension would today buy a 65-year old man an inflation-linked annuity of nearly £44,000 a year), but that's an illusion.

You see, the trouble is, the LTA isn't index-linked – it doesn't go up with inflation. By the time you come to retire, £1.25m won't be worth what it is today. In fact, if you're in your 40s, you are at much more risk of breaching the LTA than you might believe.

And if you are in your early 30s, the chances are, no matter how small your pot nor how modest your contributions, your fund will fall foul of the chancellor's pension raid. Unless, of course, you work for the government, with an early retirement age and a defined benefit pension. Prepare to be outraged.

The government needs your pension

Before Bernie Madoff, probably the most famous high-flying crook was Mirror Group proprietor Robert Maxwell. Maxwell would have died in prison if his naked body hadn't been found in 1991, floating face down in the sea in the wake of his super-yacht, the Lady Ghislaine.

Madoff defrauded investors of their investments. Maxwell's crime was yet more heinous – he stole his employees' pensions. But in the worst-run countries, the biggest threat is not dodgy employers, but the threat of the government itself raiding pension funds to prop up national finances.

A couple of years ago, Argentinians found that their government was raiding the state Pension Sustainability Guarantee Fund (FGS) by forcing the fund to lend it money, having previously taken over $29bn of privately managed pension funds in 2008.

In 2010, there were government tax raids on private pensions in Portugal, Hungary, Bolivia and Ireland. Last

year, Poland annexed half of private pensions.

Now the UK has joined this tragic roll. The government is after your pension savings. It's being crafty about it. Osborne, like every other chancellor in history, knows that pensions are both boring and complicated, and all fraudsters know that when the mark (in this case, you) gets bored, their attention drifts. So I'll explain exactly how he's going about it here. But why does the government need our pension funds in the first place?

The numbers tell the whole story. According to the Office for Budgetary Responsibility (OBR), government spending came to more than £700bn last year. That's almost 45% of GDP – a ratio only ever exceeded in Britain's economic nadir of the late 1970s.

Tax receipts, however, 'only' totalled £557bn (37% of GDP). Other revenues (including the sale of Royal Mail) took receipts up to £593bn. This leaves us £110bn (7% of GDP) short. We have to borrow that shortfall. But we're already nearly £1,300bn in debt, which means £50bn of our deficit (our annual overspend) consists of interest payments at
an average rate of 3.9%.

This makes us very vulnerable to a re-appearance of inflation, which would push rates up.
So far, so-called 'austerity' has seen government spending fall by – well, nothing actually. Spending keeps rising, while politicians of various stripes talk about inflation-adjusted spending 'cuts'.

In 2014, Osborne is targeting £12bn of spending cuts from the almost-£200bn welfare budget, but that won't stop all other areas of spending from rising. To balance the budget, we need to find £120bn, not £12bn, but once unleashed, entitlement spending is hard to rein in.

State pensions (£83bn) already account for almost half of the £180bn social security budget. Cameron's courting of the grey vote means he has promised a "triple lock" (so pensions will rise by a minimum of 2.5% a year), ruling out any cost savings there.

Then there are public sector pensions, which cost a further £36bn. There is (in most cases) no fund to pay public sector pensions from. Instead, the government uses pension contributions from existing workers. With pensioners living longer and longer, the contributions (£25bn) now only fund two-thirds of the claims. And this deficit will rise by £1.5bn-£2bn a year.

The long and the short of it is that six years ago, before the crisis, government finances were largely in balance.

We could have had a surplus – ie, saved some money – but Gordon Brown believed that tax revenues from the credit bubble were structural (that is, long term) rather than cyclical (remember "no more boom and bust"?), and so he spent the surplus.

For the six years post-crisis, however, while spending has grown at an average of 4.4% a year, government revenues have only grown by 1.3%. Over the next six years the plan is to restrict the growth in annual government spending to 1.6%. Yet even if this is achieved, total government spending will still reach £760bn in 2017-2018.

The public finances watchdog, the OBR, assumes that government receipts and spending will balance by 2018. But tax revenues today are only £557bn. So we're looking at our current annual deficit of £110bn near-doubling to over £200bn by 2018, and it's tax revenues that are expected to bridge that gap.

The only way that can happen is for total tax receipts to rise by almost 5% a year between now and 2018. Assuming you earn more than £26,000 a year, it's you and I who will have to pay for that.

But there's a problem. Income tax revenues total around £155bn. About £2.7bn goes back in tax credits to those in low-paid jobs. This means the top 1% of earners (the 300,000 people on more than £150,000 a year) already pay £42bn in income tax, a huge chunk of net receipts.

So unless it's to overhaul its entire spending edifice, parliament will have to tax the rich more, and do so in more innovative, tricky ways. So you can see why pensions have become a target.

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The eighth wonder of the world

There is a reason why calls to promote financial literacy in the classroom have come to naught. Politicians don't like the idea that the populace might see through the inflation component of growth.

No lesser mind than Albert Einstein reputedly called the power of compounding interest "the eighth wonder of the world", and it certainly distorts numbers massively over time. It's this eighth wonder that will do the chancellor's dirty work for him.

The biggest problem with writing about pensions (apart from how tedious the subject is) is that whatever representative figures are used, they aren't going to relate to your precise situation. For the remainder of this article, I will keep all assumptions constant for illustrative effect.

Since history suggests that stock-market indices double roughly every nine years, I will illustrate what will happen for a saver who is currently 36 years from retirement.

Today, that makes him (men retire at 66) 30 years old. However, by the time he actually retires, the retirement age could easily have risen by five to ten years, and so the following figures probably actually apply to a 40-year old.

Starting from 6 April, unless you apply before then for fixed protection at £1.5m (see below), all private pensions will have their LTA lowered to £1.25m. When I was first informed of this, I was led to believe this meant that the maximum total contribution I could make to my pension was £1.25m, but in fact, it refers to the value of your pension pot when vested, ie, it's the value of what you end up with, not what you put in.

You're probably still feeling quite relaxed. This is because we still don't teach financial literacy in school. If I instead told you that if you're 40 and you have a pension pot of at least £32,000, you're almost certainly into punitive taxation territory already, you might start to sit up.

From 6 April, the LTA will permit you to accumulate a pension fund of no more than £1.25m before you incur punitive tax rates. The 25% tax-free sum you can take out when you cash in your fund will be subject to a whopping 55% tax rate on any funds over £1.25m.

On top of which, any income earned on the remainder of your fund (again over the £1.25m limit) will be subject to an extra income tax of 25% on top of your higher rate. That means a marginal tax rate of between 55% and 58.75% (if you're a 45% taxpayer) on your income – ouch.

Still, you're thinking: £1.25m would be a fine thing, but the chances are none of this will ever apply to me. That's where you're wrong. Assuming no change in the threshold, this 55% tax rate could hit even the most modest of today's savers. That's because the £1.25m threshold refers to the future value of your money,

not its present value.

Consider inflation for a moment. Every 12 years since 1962, the value of your money has halved. Yet, even though saving for your pension is the most long-term investment you will ever make, and therefore the most vulnerable to inflation, the LTA is not indexed to inflation and draws you nearer to its maw each year that you save. So, what size of fund is actually at risk from Osborne's punitive 55% tax raid?

You needn't be rich to be a target

Despite financial health warnings to the contrary, the past is not just our best guide to future performance, it's probably our only reliable one. Over the last 52 years, the FTSE All-Share Index has returned an average of 6.87% per year. Over the same period inflation (measured by the retail prices index) has averaged 5.64%.

So, the stock market index has barely kept up with the real value of money, returning just 1.2% after inflation – almost all of which will have been taken as advisory fees, administration costs and management charges by most funds, leaving the poor investor barely above water.

So, here's the damage: a 30-year old man, looking to retire at the state pension age of 66, will be hit by Osborne's tax if he has a pot today of £107,000. In other words, if history roughly repeats itself, that £107,000 will be worth a bit more than £1.25m in 36 years' time. That in itself is a concern.

Today, £107,000 would buy you an index-linked annuity of about £300 a month. Even with the state pension on top, that's not going to fund a comfortable retirement for the average couple. So it's already pretty clear that Osborne's raid isn't targeting the rich, but those who can barely get by.

All the same, you might think that £107,000 still sounds like a lot for a young man to have in his fund. But it gets worse – a lot worse – because we haven't considered three other crucial factors yet.

First and most significant is that while 'real' returns from the All-Share Index may have averaged a miserly 1.2% over the years, that's not including reinvested dividends. Even in today's ultra-low yield environment, it is not hard for an income fund to hold a portfolio yielding 4.5%, which is the rate that the dividend yield has roughly averaged over the last half century.

So the total nominal return (which is what Osborne plans to tax) in the past has averaged 5.64% from inflation, 1.2% 'real' share price appreciation on top, and a 4.5% dividend yield. That's a total nominal return of about 11.4%.

If that's the case, then it implies that our 30-year old man, looking to retire at 66, can expect to be hit by the chancellor's 55% penalty if his pension pot today is not £107,000, but just £21,000!

Secondly, of course, there are the ongoing contributions. Most 30-year olds don't tend to have £21,000 lump-sum pension pots that they never plan to add to. They save by making regular contributions instead. But even if he starts with no lump sum at all, our hapless saver can't put more than £47 a week into his pension without becoming subject to Osborne's punitive 55% tax hit.

The third and final factor to consider is that in 36 years' time, we'll no longer be able to retire at 66. The nation's finances can't possibly support it. Retirement – or at least the state pension age – will be pushed back and back. It's more likely, given the deteriorating funding outlook and increased longevity, that retirement for today's 30-year olds will be closer to 76 than 66.

Again, if that's the case, a 30-year old's pension pot today of just £6,760 – even if he never adds to it – assuming a nominal return of 11.4% a year, will be sufficient to come under the tax raid criteria. Horrifyingly, a regular savings plan started today and of no more than £14.91 a week would be sufficient to trigger the 'rich man's' tax raid.

For most of us, the two biggest purchases of our lives are our houses and our pensions. But this is why financial literacy isn't taught in school. If it was, we'd all know that government spending is unsustainable

and that the government debt that currently bridges the gap is only affordable with ultra-low rates.

The young, already unable to afford to buy their own homes due to ultra-low rates driving up prices, should be up in arms against this tax raid on their retirement savings. It is only the poverty of their education and the brevity of their attention spans that keeps them less than blissfully ignorant.

Of course, all of these rules can and may change, as John Stepek notes. But if you were feeling relaxed up until now about the LTA and its implications for your retirement planning, I hope these sums have given you a bit of a wake-up call.

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How to protect your pension pot – but you have to act fast

As James notes above, the Lifetime Allowance (LTA) for pension saving is about to change, falling from £1.5m to £1.25m from 6 April, *writes John Stepek*. If your pension pot is likely to breach the £1.25m, you could consider applying for 'fixed protection 2014', which locks in the LTA at £1.5m.

You don't have to be about to retire to consider this – as AJ Bell/Sippcentre notes, "someone in their 40s with pension benefits close to £1m might… consider applying for fixed protection 2014, because, even if they don't plan on making any further pension contributions, investment growth could push the value of their pension benefits above the reduced LTA of £1.25m."

There are restrictions involved – you can't make any further pension contributions (or you'll lose the protection) – so it's worth discussing with an adviser (and possibly your employer) before you take the leap, particularly if you have a defined benefit (final salary) scheme. However, you'd have to be quick if you do decide to go for this option – you can apply online at the HMRC website, but you have to do it before the LTA changes.

A less urgent option is 'individual protection 2014'. To claim, you have to have a pension pot worth £1.25m or above. This gives you an LTA equal to the value of your pension rights on 5 April, up to a maximum of £1.5m (so if your fund was valued at £1.3m, that would be your LTA).

You can still contribute to your pension without losing this protection (so some experts suggest that this might be a good option if your employer is unable or unwilling to offer higher pay in place of pension contributions), but if you breach your personalised LTA, you'll end up paying tax on the excess. According to the HMRC website, you should be able to apply for this protection from August 2014.

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