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BUDGETREVIEW

March 2005

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Financial issues for retirement emerged as a key theme in the 2005 Budget. Existing pensioners were wooed with a package of additional benefits from the State, while further, limited measures were announced in the drive to support provision for future retirements.

BUDGET 2005 Pensioners to the fore

Neither was a surprise, of course. It is becoming a recognised fact that the number of pensioners is growing significantly, and they are becoming a more influential electoral force; they were therefore always going to be candidates for handouts in an election year.

On the benefit provision side, we are still going through seemingly endless major legislative upheaval, with details dripping out as fast as the civil servants can draft them. It would have been surprising therefore if the process had been interrupted at this stage by the announcement of any major policy change. We did, however, get an indication of a couple more of those details, which we'll touch on later.

Of course a pension arrangement is not the sole means of making financial provision for retirement, and the announcement that the current maximum contribution rate to an Individual Savings Account is to be continued until at least 2010 will be welcomed. We await the publication of the final report of the Pensions Commission in the autumn, which will make recommendations as to how saving for retirement should be encouraged – or enforced. Recent surveys showing that around 40% of people with access to their employer's pension scheme have not taken it up will give ammunition to those pressing for compulsion.

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Ultra-long gilts

The trend for pension scheme trustees to reduce investment risk relative to their liabilities has identified a demand for "risk-free" assets such as government bonds (or gilts) with cash flow profiles similar to those of a typical pension scheme's liabilities. As pension scheme liabilities typically stretch far beyond the term of current gilts in issue – the longest gilt currently matures in 2038 – the Government has recently completed a consultation process on whether it should issue "ultra-long" gilts with maturities of up to 50 years in order that asset and liability cash-flows can be more precisely matched.

The conclusion of the consultation process is that "significant and sustainable" demand exists and, as such, the Government will begin issuing such gilts by the middle of the year. Initially, gilts paying a fixed interest rate will be issued, with index-linked gilt issues (where interest payments are linked to inflation) following later in the year. The advantage to the Government of issuing such instruments in the face of such demand, of course, is that the cost of financing Government debt will reduce.

For those pension schemes wishing to match (and who can afford to match!) their liabilities, we regard this announcement as a positive step.
We are particularly supportive of the move to issue index-linked gilts as they come closer to being the ultimate matching asset from a pension scheme perspective. Fixed-interest gilts, whilst offering certainty of return in absolute terms, offer no protection should future inflation exceed current expectations. In addition, increased liquidity in long-dated gilts might well cause some reduction in prices, with the corresponding increase in yields leading to a reduction in the cost of funding pension liabilities via a pension scheme or through the annuity market.

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Pension tax simplification

We have known for some time that the 2005 Finance Act would be used to make necessary or desirable adjustments to the new tax regime legislation as set out in last year's Finance Act, once the full implications of the initial legislation were understood. The Inland Revenue issued a Technical Note in February, outlining a number of proposed amendments. Most were largely technical in nature but the more significant included a backtracking from the requirement that schemes with less than 50 members would have to buy out pensions. They also intend to adjust the rules relating to dependants' pensions on death after retirement to avoid what they saw as inappropriate avoidance of the lifetime allowance through restructuring of retirement benefits. Detail on the changes is still needed.

The Budget Notes published on Wednesday announced a couple of further potential changes. There will be more consultation on how to minimise the discrepancy between the calculation of tax-free cash under the scheme pension and the lifetime annuity routes. They say the outcome of the review will be announced before the 2005 pre-Budget report with the intention to make any changes in the 2006 Finance Act. The thought of such an important issue not being resolved until so close to the implementation date of April 2006 causes much concern. However, we understand the Inland Revenue's intention is to clarify the policy as far in advance as possible, and to accept that the final rules will apply from the start of the new regime, even if the legislation in the Finance Act 2006 is not enacted until later in the year.

The other area for change announced in the Budget concerns the proposed statutory override to scheme rules to prevent sudden additional liabilities arising because of the removal of current Inland Revenue limits and the earnings cap. There has been concern that the legislation as currently drafted does not go far enough to give schemes (and their sponsoring employers) the protection they need. For instance, as drafted, the rules would only prevent increases in liability because of the removal of the earnings cap – any current limitation of benefit because of the application of other limits would immediately cease to apply. Furthermore, the override would currently only apply for three years from April 2006, or until any earlier change is made to the scheme rules. Whilst this would give some schemes time to introduce their own limits, legal opinion suggests that, in some cases, this may not be possible. What has now been proposed is that the override period will be extended to five years, with an order-making power to extend this further. Whilst this would be a step in the right direction, we hope that when we see the full details of the intended change, they go further towards correcting all the shortcomings that have been raised.

We do still talk of pension tax simplification – it is, but the legislators are making a pretty good job of complicating it!

Other issues

Coming back to what we already know is complicated... one other pension-related issue covered is the confirmation that, as announced in the pre-Budget report last December, the £100,000 final remuneration limit for calculating tax-free cash for 1987-89 members will be increased to £105,600 from 6 April 2005. Relatively few people are caught by this – generally only those that joined an occupational scheme between 17 March 1987 and 31 May 1989 - and, of course, even fewer will be retiring before the existing limit rules are swept away in 2006. However, increasing the maximum final remuneration could affect some people who are not retiring, but who will be able to carry forward a slightly higher percentage of tax-free cash in respect of pre-April 2006 service rights into the new regime.

Finally, the Inland Revenue has confirmed, again as expected, that individuals who enter into a new civil partnership that will be available towards the end of this year, will be treated for all tax purposes in the same way as husband and wife. This will include pension scheme legislation, so that such a partner will no longer have to have been to some degree dependent on their pension scheme member partner to be able to receive a survivor's pension.

Conclusion

Underneath the election froth, the real Budget made a few small steps along the road to what we all hope will be a more sustainable and straightforward environment for funding for retirement. However, what we are really awaiting from the Inland Revenue are the final details on the tax simplification legislation – both in principle and practice. Once we have those, we will be in a position to start talking definitively with clients about the details of how they could be affected and what action needs to be taken. The next month or so should hopefully see further developments.

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