



• Actuarial, Trustee & Administration Services •

Rt Hon. Ed Balls MP
H M Treasury
Parliament Street
London
SW1P 3AG

8th January 2007
Our Ref: ajbg/misc/ajb04/jb

Dear Mr Balls

Pension Announcements in Pre-Budget Report on 6th December 2006

I write further to the recent announcements regarding pensions in the Pre-Budget Report (PBR).

I am the Managing Director of A J Bell Group, an actuarial consultancy and SIPP provider based in Manchester. We currently have over £3bn under trusteeship and are attracting approximately £120m per month of new pension money. The majority of this business is being attracted into our low-cost flexible Self-Invested Personal Pension (SIPP) products and comes both via independent financial intermediaries and direct from pension savers.

I have personally been heavily involved in the consultation over the pensions legislation now enshrined in Finance Act 2004. I am also involved with a small team from HMRC that is dedicated to helping iron out some of the post A-Day simplification wrinkles.

Whilst I have been openly critical about specific aspects of the new pensions legislation, I have been a major supporter of the motivation and intentions behind this new legislation. Indeed, whilst many in our industry were lamenting the announcement in the 2005 PBR in relation to residential property, I saw this as being a victory for common sense, albeit I was not totally enamoured about the timing and manner in which the announcement was made.

I also generally support the detailed technical improvements announced in this most recent PBR, some of which were partly as a result of the work with the aforementioned HMRC team.

I am, however, vehemently opposed to one particular aspect: the proposal to introduce a penal tax charge on residual Alternatively Secured Pension (ASP) funds (left in the event of the death of the member and their dependant(s)).

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I believe that these proposals contradict existing Government policy and serve only to undermine the new pension regime and will distort the actions of pensions savers.

Before I make my case, I think it would be useful if I set out my understanding of Government policy on this area of pensions. Clearly, if I have misinterpreted any aspects of policy then I am happy to reconsider some of my views.

The main strands of Government policy in this area, I believe, are:-

- a) Tax relief is granted on pension contributions and investment income/growth [within a pension fund] in return for pension savers converting their pension fund, at some stage before the age of 75, into a secure pension.
- b) The Government does not wish to see pension schemes being used primarily as vehicles for savers to pass on assets to their heirs.
- c) Security, flexibility, choice and simplicity are all key aspects of the pensions infrastructure that the Government wishes to create.
- d) The Government wants to ensure that pension savings are not frittered away, thereby leaving pension savers to fall back on to state benefits.
- e) The Government does not seek to encourage/force individuals to use their pension fund assets to buy an annuity as a means to underpin the supply line for Government borrowing.

These principles of policy are demonstrated very clearly in the document entitled "The Annuities Market" published on 6th December 2006 by H M Treasury.

The Government's policy, as I understand it, is that pension savers must use their pension fund to provide a secure (but not guaranteed) income. Clearly if Government policy were that a guaranteed income must ultimately be provided then compulsory annuitisation would be a natural consequence in all cases. Indeed, some of the more flexible annuity products (e.g. investment linked annuities) and unsecured pensions (USP) would be prohibited if this were the case as these types of products are potentially more risky than conventional annuities.

I am well aware of the background to the debate on not forcing those with religious objections to annuitise compulsorily. It seems clear that the Government has sensibly conceded that it would not be practicable to distinguish between those with religious objections and those who choose not to buy an annuity for different reasons.

Perhaps the most important sentence in the PBR announcements and supporting documents appears on page three of the Executive Summary of the Annuities Market document, "More than half of an individual's pension fund may consist of accumulated tax relief: the fundamental reason for requiring annuitisation rather than allowing funds to be passed on to heirs. There would be no rationale for the tax payer to subsidise bequests through pensions tax relief".

This signals that the Government's desire for pension savers to annuitise is driven by an objection to bequests by pension savers to their heirs being subsidised by taxpayers. It is difficult to argue with this objection and I do not intend to.

I conclude that this issue is more important than, say, any paternalistic protection of pension savers by forcing them to annuities.

If this conclusion is right then surely there is a level of tax that could be deducted from residual ASP funds that would render the Government's fears on this front non-existent. This would simplify administration and be easy to explain to potential savers.

In fact, whether we like it or not, that is the position we have reached, only the effective tax rate is 82% for the majority as per the PBR proposals.

If the Annuities Market report reflects the entirety of Government Policy then it leads me to believe that as long as pension savers use their pension fund to provide themselves with a secure income, then it is just a matter of debate as to what the fair rate of tax is to charge on genuinely unused pension savings, this allowing the residual funds to be passed down to individual's heirs after a neutralising tax.

I would not contest that the effective tax rate should exceed 50%, equating to the "more than half... may consist of accumulated tax relief" comment referred to above. I would however argue that it is not as high as 82%, which will be the current effective rate in most cases.

I also take at face value that it is the Government's intention to encourage pension saving. There is no doubt that many pension savers, and possibly more importantly "would-be" pension savers are put off by the perception that pension savings are a black hole. A significant driver behind this perception is a requirement for individuals to annuitise compulsorily. There has been a marked improvement in consumers' attitudes towards pensions since Finance Act 2004 was implemented earlier this year, and a part of this improvement is down to the removal of the requirement for compulsory annuitisation. Unfortunately, much of this good work has been undone as a result of the PBR announcements.

I made this point about residential property and I also make it about the alternatives to annuitisation i.e. ASP. Much of the demand is aspirational. Many individuals would have started pension saving with a view to ultimately buying a residential property within their pension fund (had the rules not changed). Practicalities would have dictated however that in the vast majority of cases this would not have happened. A similar situation occurs with ASP as an alternative to the purchase of an annuity. Many consumers will save into pensions on the understanding that the money is not "lost" on their death. In the final analysis however, the vast majority will realise, with or without advice, that an annuity is the only sensible option at the point of retirement.

The hard fact is that for the vast majority of pension funds that accumulate funds to a figure below £100,000, in today's terms, an annuity purchase is the only realistic option. This position will remain whatever the rules on death in ASP.

I have enclosed a letter that I have recently received [totally unprompted] from clients of ours. This letter clearly demonstrates the adverse effect of the recent proposals and is evidence of the inevitable long-term impact that they will have on pension savings in the future.

Maintaining simplicity is not an argument I would accept for implementing the latest proposals. In fact I would argue strongly to the contrary. The rules for paying out death benefits in the event of death in ASP is now unduly complicated, as a result of the new IHT legislation introduced in Finance Act 2006 and PBR proposals.

Any piece of tax legislation should not have significant and unjustified “cliff-edge” points. Under the PBR proposals, the tax treatment in the event of someone dying the day before age 75 and the day after age 75 is markedly different.

If an individual dies immediately before age 75 with uncrystallised funds, then in the vast majority of cases the full fund will be payable as a lump sum with no tax due (including Inheritance Tax).

If an individual dies immediately before age 75, whilst in unsecured pension (USP), then the pension fund suffers a 35% tax charge. The residual fund is then available to pay to heirs as a lump sum without any further tax (including Inheritance Tax).

If the pension scheme member dies a day after 75 whilst in ASP (with no dependants), then the heirs only receive 18p in the £1. This equates to an 82% tax rate and is calculated using a generous interpretation of the tax legislation i.e. the tax rate could be argued to be higher.

If an individual reaches age 75 and chooses to wind up his pension fund and take the whole lot as a lump sum, spend it on a round the world cruise and then returns to the UK to rely on state benefits, the effective tax rate on cashing in the pension fund would be 70% (made up of the unauthorised payments charge, the unauthorised payments surcharge and the scheme sanction charge).

Does it make sense in tax legislation to penalise somebody who saves into a pension scheme, uses that pension scheme to provide benefits in accordance with the rules, and then ultimately dies leaving no dependants, more than someone who chooses to wind up their pension fund, blow the money and fall back on state benefits? I would suggest not. This cannot be right.

So what is a fair neutralising tax rate such that the taxpayer is not subsidising monies passed down to the next generation, in respect of unused pension savings?

Unfortunately, I do not have access to the figures behind your policy.

I would accept however that the figure lies somewhere between 50% and 82%, but most definitely nearer to the lower than the upper figure.

I would argue that the effective rate of tax, including Inheritance Tax, must be less than 70%, otherwise the pensions tax legislation will be distorted.

By this, I mean that advisers (in some cases) will be obliged to advise clients to wind up their pension fund, for fear of the client suffering a combination of Inheritance Tax, the unauthorised payments charge, the unauthorised payments surcharge and the scheme sanction charge (dis-regarding any potential for a de-registration charge to be applied).

I also personally believe, for what it is worth, that the very notion of a transfer lump sum death benefit (TLSDB) has always been flawed and the only good thing I can say, is that it is [sorry was] better than compulsory annuitisation. I see no logic in any Government allowing individuals to pass on their pension savings to the next generation in the form of an inherited pension fund, as the TLSDB achieved.

Surely it makes far more sense to distribute the unused pension monies once they have served their purpose, to the member's heirs, after a neutralising tax. At that stage, if the recipients are entitled to contribute into pensions, then they can use these funds to contribute under the rules applying to all pension savers.

So, for the avoidance of doubt, this is not a plea to retain the TLSDB. It is a plea for common sense and for the Government to apply existing published policy in a common sense way.

So how do we achieve this?

My proposals are quite simple.

Firstly, to allow residual ASP funds to be paid to heirs as a lump sum after a one-off standing tax charge. This will be in lieu of Inheritance Tax, and any other tax charges that maybe otherwise be applied.

My suggestion for this rate of tax is 55%, acting as a neutralising tax charge to recoup the tax reliefs previously granted.

This is not inconsistent with the 0%/35% tax position on death before age 75. Also, it is not as penal a tax charge as would apply if the individual had abused the authorised payment rules.

It is also consistent with the treatment of pension savings in excess of the lifetime allowance ie. a 55% tax rate.

We should also be careful about the unintended consequences of the PBR proposals. Those that advise at the edge of the industry will come up with more weird and wonderful schemes to circumvent this 82% tax charge. There is no doubt that the higher the tax charge that one is seeking to avoid, the greater lengths that advisers and clients will go to avoid such a tax charge.

We have just seen the back of the open annuity, a Gibraltar based annuity that personally I found to be a very uneasy fit with UK pensions legislation.

Let me also predict that variations of this product will shortly enter the market if the PBR proposals are implemented and this will only serve to further undermine the UK's pensions tax system. A sensible tax rate on residual ASP funds will kill off, at a stroke, any demand for the creation or take-up of any such products.

Finally, despite my conclusion that the main driver of Government policy is to avoid tax subsidised bequests, I have long harboured a fear that the Government's pro-annuity stance is fuelled by a desire to minimise the cost of Government borrowing.

It is a well accepted actuarial principle that one of the most suitable types of asset to match a portfolio of annuity liabilities with, is a portfolio of gilts. Further, one doesn't need to be an economist to realise that the greater the demand for gilts then the lower the yield on these gilts and hence the lower the cost of Government borrowing.

I would appreciate an assurance that Government pro-compulsory annuity stance is in no way driven by a desire to maintain the supply line and hence minimise the cost of Government borrowing.

In conclusion, individuals will always argue that annuities represent poor value for money, however, in a period of low interest rates and increasing longevity, this perception is unfortunately a fact of life. As the Annuities Market document acknowledges, there is a lack of understanding of annuities and I can only say that the increasing number of annuity policies being purchased is a testament to the fact that advisers and clients ultimately realise that if they want security of income then an annuity is the only realistic choice. This will continue whatever the rules are on ASP.

However, these distorted rules as proposed in the PBR will only serve to discourage new pension savers and to disenfranchise existing pension savers who expected the Government to deliver on their promise of simplicity, flexibility and choice for those pension savers.

All I do at this juncture is urge that the Government seriously reconsiders its proposals in this area and chooses not to undermine several years of hard work along with the associated goodwill on behalf of the pension industry that has been created in forming the pension simplification rules. Continuing down the proposed route will also serve to undermine consumer trust and confidence.

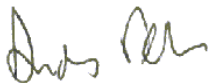
It is impossible to get such a monumental change of legislation as pensions simplification right at the first attempt. Indeed, I applaud on virtually all fronts the integrity and manner in which these new rules [contained in Finance Act 2004] have been introduced. We must not however forget the reason why our pensions legislation was in such a mess as at 5th April 2006. It had been built up layer by layer over 30 years, with untold tinkering by successive Governments. I urge that we do not repeat this same mistake and that the Government remains true to its original promise that the pensions legislation will provide security, simplicity, flexibility and choice so that this legislation is not seen as a crutch to support Government borrowing or as a means to raise additional taxation revenues with unfair tax rates.

I would be more than happy to debate any of these issues with members of the Government, Treasury and/or HMRC if the opportunity presents itself.

This letter has been written as an open letter and sent to various publications and industry representative bodies.

Kind regards.

Yours sincerely



**Andy Bell BSc FIA
Managing Director**

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