Kingston Smith Financial Advisers

Your potential, our expertise

Alternatives to pensions for professionals and their clients

by David Hume

There are many reasons why our professional connections, and their clients, are looking for alternatives to pensions to build a fund for their retirements, but why should you give these alternatives serious consideration?

With cuts to pension's tax relief for higher earners hitting investors in the pocket it may be that they are looking at ways to complement their current pension arrangements rather than replace them. One thing I can guarantee you is that the favourable tax treatment of pensions will continue to be considered a target for the UK government as a way of raising funds and it is likely that future legislation will be introduced to further alter the current pension regime.

To recap, since 2012, wealthier pension savers have seen their lifetime allowance reduced from £1.8 million to the current £1.055 million figure.

The introduction of the tapered annual allowance (TPA) in April 2016 also negatively impacted higher income earners. Many of our professional connections are considered higher hitters who have a 'threshold income' in excess of £110,000 in any tax year and will have their adjusted income tested to see if this is in excess of £150,000 in that tax year. If both tests are met then the standard £40,000 Annual Allowance (AA) is reduced by £1 for every £2 of adjusted income over £150,000 in a tax year. This restricts the level of tax-efficient pension funding which high earners and their employers can make into pension schemes.

The maximum AA reduction is £30,000, so those individuals who have an adjusted income of £210,000, or more, will have an AA of £10,000 from 2016/17 onwards. Hence, if you are impacted by this reduction you may wish to consider alternatives for investing this annual budget of up to £30,000 elsewhere.

It is possible to carry forward unused allowances from the previous three tax years if you had been a member of a registered pension scheme. The carry forward of unused AA from previous tax years still provides higher earners the opportunity to maximise tax-relieved contributions into pensions if they have not maximised these allowances in the past.

According to the Office for National Statistics (ONS) an estimated 364,000 people have been affected by the TPA on pensions. It is important that you review your pension contribution limits as those who breach their AA may face a tax charge that could be thousands of pounds. Please consider how many of your own clients will have been impacted by this legislation? The tax charge will be calculated based on taxable income and the amount put into a pension that is in excess of your AA. I recommend that you seek professional advice so that you can be certain of how this impacts you personally and our team at Kingston Smith shall welcome the opportunity to hold these conversations with you.

So which investment is the best alternative to pensions that you and your clients should consider? The options are numerous and include shares, investment bonds, enterprise investment schemes (EIS), Seed enterprise investments schemes (SEIS) and venture capital trusts (VCT) to name a few.

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However, for many the starting point for diversifying your retirement provision should be an ISA.

Individual savings account (ISAs)

Many professionals who have 'maxed out' their pension allowance have started to consider ISAs as an alternative means of boosting their retirement income. These tax-free savings accounts are an attractive alternative to pensions, whether you are a high earner or basic rate taxpayer. Although you don't benefit from any tax relief on contributions into your ISA, any capital growth and any income generated is tax free. This ability to build an additional, complementary, flexible tax free lump sum and income to draw upon in your retirement is a compelling one.

With the unprecedented nominal interest rates available and the anticipated extended period of low inflation and interest rates within the UK, you can see why cash ISAs have fallen in popularity over recent years.

However, the £20,000 annual ISA limit, government cuts to pension's tax relief for high earners, has rekindled interest for the humble ISA once more. If you had been saving the maximum allowance within an ISA since their introduction, you would now have a substantial lump sum available as you would have contributed £206,560 in total since their introduction in April 1999.

Depending on your risk appetite and time horizon there are many different investment options available rather than investing in cash deposits within your ISA.

If inheritance tax planning is important to you and your clients then you may wish to consider transferring existing ISAs and / or invest future annual contributions into Alternative Investment Market (AIM) portfolio ISAs. AIM portfolio ISAs can potentially save 40% inheritance tax (IHT) on your monies held. Importantly it is still possible to access the monies held within the ISAs if required in the future, but will transfer the remaining assets not drawn upon outside your estate due to the application of the Business Relief (BR) rules after a two year holding period. The monies invested need to still remain within qualifying investments and held on death. AIM investments may be considered higher risk and are not suitable for all clients so it is important to consider speaking to our team at Kingston Smith for this more specialist investment advice.

Legislation means you are now able to transfer your ISAs to your spouse on death, your surviving spouse will receive an 'Additional Permitted Subscription' (APS) allowance, that's equal to the value of the ISA, however on the 2nd death these would fall back within the chargeable estate value.

ISAs may not be the solution for everyone, but they should be considered as one of the first alternative solutions available. For our professional connections who are looking for an alternative tax-efficient investment opportunity outside of pensions many could consider a Venture Capital Trust (VCT) or Enterprise Investment Scheme (EIS). These were both introduced by the government to encourage investment into newer, smaller UK companies by offering investors a range of tax incentives, including income tax relief. However, they are sophisticated and considered higher risk than many more mainstream investments.

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What are VCTs?*

VCTs are listed companies that invest in the shares of other companies. The VCT manager will research and select companies in which to invest. The headline tax advantage for investors is 30 per cent income tax relief on the amount they invest, up to a maximum of £200,000 each tax year. Tax relief is given as a credit against the investor's total income tax liability.

Furthermore, any dividends paid by the VCT on the shares will be tax-free which may be attractive to supplement pension income in retirement. When the client then chooses to sell the VCT, any gains they make will be free from capital gains tax.

Investors must hold the VCT for a minimum of five years to maintain the income tax relief.

What is an EIS?*

Although similarly designed to encourage investment in small, unquoted companies, typically an EIS is considered to be higher risk than a VCT because it focuses investment in fewer companies. The normal maximum investment level is up to £1m per annum, but this can be increased to £2m if the excess above the £1m is invested into knowledge-intensive companies.

Similar to a VCT, an EIS also offers the investor 30 per cent tax relief through a reduction in their income tax liability, but it also offers capital gains tax advantages by allowing an investor to defer a capital gains tax liability. This can be particularly attractive for capital gains being deferred at 28% from a property sale where these may be based on the potentially lower capital gains tax rate of 20%, applicable at that time of crystallisation for an investment.

Importantly, any future capital gain generated via the EIS investment itself will be tax-free and after holding the EIS for a two year term, it will also qualify for Business Relief for inheritance tax purposes.

On top of the above investment limits it is also possible to invest an additional £100,000 into a Seed EIS (SEIS) which attracts an even greater level of income tax relief of 50%, but the investment is less diverse and would be considered even higher risk than an EIS.

Investors must hold the EIS for a minimum of three years to maintain the income tax relief.

It is important to note that investing in smaller, newer companies carries a higher level of investment risk and is not suitable for everyone. It is therefore important to seek out professional advice from the Kingston Smith team before committing your money as this is a specialist area of advice.

Contact us

Any queries then please contact our Kingston Smith Financial Advisers team and speak to one of our financial planners.

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Information is based on our current understanding of taxation legislation and regulations. Any level and bases of, and reliefs from taxation, are subject to change.

Tax treatment is based on individual circumstances and may be subject to change in the future.

The value of investment and income from them may go down. You may not get back the original amount invested.

*Some funds will carry greater risks in return for higher potential rewards. Investment in emerging market funds can involve greater risk than is customarily associated with funds that invest in developed, more established markets. Above average price movements can be expected.

Kingston Smith Financial Advisers Ltd

Kingston Smith Financial Advisers Ltd is a joint venture between Kingston Smith and Argentis Financial Management. Argentis joined Gallagher, one of the largest risk management organisations in the world, in 2016.

Together we have created a chartered independent financial planning and wealth management business committed to high-quality service and advice that is delivered with precision and discretion.