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AJBell Investcentre

News & Views

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Welcome

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Welcome to the latest edition of my News & Views.

Firstly, many thanks to those of you who attended Investival earlier this month. It seems to get better each year. The day started with a sad but fitting tribute to our friend and colleague Mike Morrison who sadly passed away earlier this month. The messages of support and condolences have really been appreciated and these have been passed on to his wife Rita and daughter Sophie.

The day was full of interesting sessions involving high profile fund managers such as Mark Barnett, Edward Bonham Carter and Neil Woodford to name just a few. The evening was then rounded off in traditional style with a virtuoso performance from SKY Sports' Jeff Stelling.

In this edition I have summarised the thinking behind some recent lobbying activity I have undertaken on the treatment of death benefits paid from pensions. By the time of our next issue I'd hope to have received a response from the Chancellor, which I'll be happy to share.

Elsewhere I've confirmed a few details about our plans for the Lifetime ISA, explained some complex new rules which will potentially affect a number of your clients, and summarised the key points from some interesting research we've commissioned into consumer behaviours in relation to the pension freedoms.

With a pleasingly quiet budget – just a small uptick in the Lifetime and Junior ISA allowances to speak of – disappearing in our rear-view mirror, attention is now turning to the busy tax year end that will be on us before we know it ...

As always, if you have any feedback on this issue, or would like to see anything specific covered in future editions, you can let me know by email at views@ajbell.co.uk.

Let's take the doubt out of death benefits

Regular readers will be aware that I've never been happy with how death benefits have been taxed by the Government.

Things have improved a lot since the days when we had potential tax charges of 0%, 35% or 82% depending on seemingly random factors such as whether you'd gone into drawdown or not, and whether or not you were a day over or a day under 75. We lobbied for that to change, and change it did.

They've also improved from the replacement system, which taxed death benefits either at 0% or 55% based on a similar set of factors. We lobbied for that to change, and change it did – arguably becoming a little too generous in some circumstances!

We're still left with issues though – two of which have given me cause to write to the boss man at Number 11.

The first of these is the application of Inheritance Tax on pension death benefits in very limited circumstances. Readers will know that pension death benefits are 'largely' free of Inheritance Tax. Sadly, because of some anomalies in the rules, we can't get rid of 'largely'. The most relevant set of circumstances at the moment is the one where a transfer is made between pension schemes whilst the member has impaired life expectancy, and then dies within two years of the transfer. HMRC views this transaction as being subject to IHT, although the value of the transfer isn't subject to IHT – that would be too simple – the liability is subject to a complex calculation which references current annuity rates, the life expectancy at the point of transfer and the amount of time the member survived after the transfer.

The problem is that very few individuals know about this potential IHT at the point they make the transfer, and so are caught out by a hidden anomaly in the rules.

I've suggested, rather than having a system which contains hidden rules which trap the unwary, why not properly simplify the system, as the Government said it was aiming to do a couple of years ago, and create a situation where pensions genuinely are IHT free in all circumstances where there is no blatant and deliberate avoidance.

A transfer of benefits between pension schemes when made to make use of the pension freedoms clearly doesn't fall into the IHT avoidance camp. HMRC only takes the view that it may be subject to IHT because the member could have chosen to move the benefits to a scheme where discretion wasn't exercised, in spite of the fact that transfers to schemes of that nature are almost unknown.

Having mentioned discretion, or the lack of it in some schemes, this neatly brings me on to my second and arguably more meaningful proposal. Let's remove the need for scheme administrators and trustees to exercise discretion. Instead, I think the system will work better if there are two options.

Firstly, the scheme administrator can follow the most recent nomination to the letter.

Alternatively, if the scheme administrator thinks there is a chance that this isn't appropriate, the executor of the estate becomes responsible for distribution.

In both sets of circumstances the death benefits would be exempt from Inheritance Tax.

I have several reasons for thinking it is right to remove discretion:

1. Most people don't think it will be used anyway. Based on our pension freedoms survey, 50% of those in drawdown think their provider will automatically pay death benefits to their nominated beneficiary. Only 7% think the provider will exercise discretion. If people don't think discretion is exercised, it's only going to cause problems and confusion when it is.
2. Anecdotally, I hear that at least some providers pay lip service to discretion, and just pay out as per the most recent nomination. How can it be best to have a system where the Inheritance Tax status is dependent on whether or not a provider pretends to exercise discretion?
3. Properly exercising discretion – which is something we at AJ Bell do – takes time. That means increased charges and delays in the settlement of death benefits. It also leads to problems when a potential beneficiary disagrees with how the discretion has been exercised. Moving to a situation where the pension provider pays in accordance with the nomination or, if it has concerns about this, leaves the distribution in the hands of the executor who is already dealing with the distribution of the estate, must be a better option to me.
4. It will also encourage scheme members to keep their nominations up-to-date, and will encourage providers to prompt them to do so. That must be better than a situation where nominations can be years out of date because they haven't been thought about since the SIPP was established. Just think how many of your clients have had a change in their family circumstances since they last updated their nomination form. Divorce, marriage, new child or grandchild or death of a loved one should all be a trigger for you to review how your clients are intending to bequeath their pension assets.

At this stage I'm not expecting to see any immediate change in the treatment of death benefits. However, we didn't expect, or achieve, immediate change when we were lobbying on the removal of the cliff-edge tax charges – but the changes came in the end. We'll see whether we achieve the same here.

AJ Bell Investcentre Lifetime ISA Launch

I've previously expressed a little bit of scepticism when it comes to the Lifetime ISA (LISA). This isn't based around any particular issues with the product in isolation, but more that it risks further complicating what had for many years been a simple method of saving.

Although I've had some reservations, a number of readers have expressed an interest in being able to use AJ Bell Investcentre for a LISA. So I'm pleased to be able to confirm that we are hoping to make the LISA available to AJ Bell Investcentre clients during 2018. If not launched before the end of the tax year then it should be available in the months thereafter. We will confirm the exact date via communications nearer the time.

ISAs have worked well for many years and largely been seen as a success story but it still feels as though simplification may be needed in the future. We now have a long list of ISAs including Help to Buy, Innovative Finance, Cash, Junior, Stocks and Shares and most recently Lifetime ISA. Add to that the rules covering flexible ISAs and additional permitted subscriptions after death and the picture becomes even more confused.

The LISA is proving popular as an attractive savings vehicle, perhaps because you can receive up to £32,000 of bonuses from the Government (if you save the maximum allowed for the full term).

It also doesn't suffer from the big drawback linked to the Help to Buy ISA. If we cast our minds back, George Osborne told savers they would receive direct Government support for a deposit. In fact the Government bonus on a Help to Buy ISA is not paid out until the sale is completed – making it much less helpful for many and rendering the scheme useless for some. The Lifetime ISA bonus will be paid monthly from April 2018 meaning savers can make use of any investment growth and use the cash towards their house deposit rather than waiting for completion.

It's also good news for parents or grandparents with some spare cash. The Lifetime ISA has been welcomed by people who want to help their offspring get onto the property ladder or save in a tax-efficient way.

A Lifetime ISA isn't for everyone; withdrawals before age 60 are hit with a penal charge if not used to buy a first home. There has been mixed reception amongst providers. I'm pleased to say we will be one of the few offering the Lifetime ISA and helping to make investing accessible to all, particularly millennials.

Legal Entity Identifiers

We've had a few situations in the last few years where apparently innocuous rule changes have had a far bigger impact than was originally intended.

Primary amongst these was probably the Money Purchase Annual Allowance (MPAA). Given the small numbers who have historically made significant contributions after going into drawdown, it initially appeared irrelevant to almost all savers. Moving on a couple of years and we probably have approaching 1 million savers affected by it, the limit has dropped from £10,000 to £4,000 and we have far greater numbers of older people making use of flexible working. I have a horrible feeling that things are going to get messy in relation to the MPAA in years to come.

The latest contender for small regulatory change which will catch out the unwary is the Legal Entity Identifier. So what's a legal entity, why does it need identifying and what's the issue?

Legal entities will include trusts (with the exception of bare trusts), companies (both public and private), pension funds (with the exception of SIPPs), charities and unincorporated bodies.

Investors who are deemed to be legal entities will have to obtain an LEI in order to continue to invest in products traded on exchanges after **3 January 2018**. This is the date on which the MiFID II regulations, under which the LEI rules fall, take effect in the UK.

The LEI itself is an alphanumeric reference code, 20 characters in length. It is unique to each legal entity.

It will be used to identify the legal entity whenever it takes part in a financial transaction involving a reportable instrument. Reportable instruments include most investments that are traded on recognised exchanges, such as equities, ETFs, investment trusts and bonds. Most funds, however, are not reportable.

The reporting will allow regulatory authorities, such as the FCA, to monitor activity with particular emphasis on potential market abuse and market manipulation.

All entities classified as the "buyer/seller" under the MiFID II rules will need to register for an LEI. This applies regardless of whether the entity is using a financial adviser or not (or whether that adviser is acting under a discretionary or advisory mandate).

SIPPs don't have to obtain an LEI on the basis that the member is considered the buyer, so the SIPP is not deemed to be an entity. For SIPPs therefore the member's National Insurance number will then serve to identify the member.

Just to confuse things, SSASs are viewed as legal entities, with the SSAS trust categorised as the buyer/seller. All SSASs, including single-member SSASs, will need to obtain an LEI before 3 January 2018 to continue to trade in reportable securities through the AJ Bell Investcentre Funds & Shares Service.

Although from a pensions perspective all member-trustees of a SSAS are jointly responsible for investment decisions, for LEI purposes only one member-trustee can be classified as the investment decision maker. We will be recording the member-trustee chosen as our registered contact for the SSAS as this party.

We are aware that some pension administrators have taken the view that single-member SSASs do not need to obtain an LEI. This is not our understanding, although we are in correspondence with the FCA to obtain a definitive answer. We may only be able to continue offering a broking service to single member SSASs if they obtain an LEI and provide it to us.

The responsibility for obtaining the LEI rests with the customer. For the SSASs we administer, our SSAS department are offering assistance. This does not apply to SSASs administered by other firms and for which we simply provide broking services.

And of course the LEI comes with a cost. LEIs can be obtained, for a fee, from the London Stock Exchange (LSE). It charges an application fee of £115 + VAT and renewal, which must take place every year – this will cost £70 plus VAT. Customers can apply for an LEI themselves (or for SSASs their scheme administrator may assist) by visiting www.lseg.com/LEI.

One interesting wrinkle in the rules that is specifically relevant to advisers relates to whether or not a discretionary or advisory mandate is being used.

Each advice firm acting under a discretionary mandate needs its own LEI, and this will appear in the 'decision maker' field of the transaction report for relevant client accounts. The actual adviser themselves will also be identified in the 'investment decision within firm' field by their National Insurance number.

If the advice firm is acting under an advisory mandate, the firm's client is deemed to be the 'decision maker' and the normal LEI rules apply to the legal entity.

We're receiving more and more questions about LEIs and the one piece of advice I'd offer is – encourage your clients not to leave it to the last minute to obtain one. There's likely to be a last minute rush, and you don't want to find your clients can't trade in the New Year.

Once the LEI has been obtained, please provide it to us at MIFIDinformation@ajbell.co.uk as a matter of priority. Remember, no LEI; no trade.

Pension freedoms research

With the pension freedoms being trailed by the then Chancellor as the most significant change to pensions in over 100 years, it perhaps isn't too surprising that we continue to be bombarded with analysis and a huge range of opinions on whether they are a good or bad thing.

In the last week alone I've seen expressions ranging from unmitigated disaster to the best thing that has ever happened to pensions. Interestingly the latter phrase was used by a consumer making use of the freedoms, whilst the former was used by a self-proclaimed consumer champion – which is an interesting dynamic in itself!

One thing I've felt has been lacking amongst all of these opinions has been a statistical analysis of the motivations of those making use of the freedoms. Don't get me wrong, we've had plenty of statistics about the number of withdrawals, the number of people making those withdrawals, the amounts and percentages withdrawn, and even the amount of tax paid and recovered. What has been lacking is some decent research into why those choices were being made and what the plans of those individuals were for the future.

It was with a view to shedding a light on some of these issues that we decided to commission some research of our own. Some of the findings were illuminating.

Most of the research involved interviews with 250 individuals who had entered drawdown since 6 April 2015, although a subset of the questions were asked of a broader group of more than 1,400 people with a pension managed online.

One of the main themes that came out of the research was that those going into drawdown have done so because they hold the opinion that this gives them more control. Over half (52%) of those surveyed said the reason for choosing drawdown over an annuity was that it allowed them to maintain control. A much lower percentage cited the poor value of annuities (30%) or improved death benefits (22%).

This theme of control was reinforced in the answer to a question regarding the extent to which they did feel in control. Over three-quarters of those surveyed (78%) indicated that they felt totally or somewhat in control, with only 16% saying they did not feel in control.

I think this is an important prompt for us all in how most clients want to be supported in drawdown. It is far more important to many that they are provided with the advice and information that enables them to have a sense of control, rather than what might have been considered to be more tangible benefits, such as lower taxation.

The research, to me at least, also gave me encouragement that the majority of those in drawdown are behaving rationally and responsibly. As just a few examples:

- Two thirds of those surveyed review the level of income they're withdrawing at least once a year – it is worrying that 26% indicated that they do not review their income at all, although I'm sure a proportion of these individuals will not be solely relying on their drawdown income.
- More than three-quarters of respondents are withdrawing the amount they need from the fund, or less than that. Only 10% indicated they were withdrawing more than they needed.
- Over 40% of respondents were planning on the income they withdrew staying the same. And a greater number were already planning on reducing their income rather than increasing it.
- Over 40% of those surveyed are using withdrawals for day-to-day living. A much higher percentage than those just sticking the funds in a bank account outside the pension – which isn't an option that will make sense for many.

Probably the biggest area of concern I have with the survey data, and this is covered in more depth elsewhere in News & Views, is the lack of understanding of how pension death benefits work.

The lack of understanding wasn't limited to one area either. Only 7% of individuals in drawdown understood that, in most cases, death benefits were subject to the discretion of the scheme trustees. 50% of those in drawdown thought their nomination would automatically be followed, with no discretion used – that is clearly alarming as, under current rules, this would mean the death benefits were subject to IHT.

At least equally as concerning was the fact that only 4% of people holding a pension understood how pensions were taxed on death. Over 60% just admitted that they didn't know, with larger numbers also choosing each of the incorrect options that were offered rather than the correct one.

Very alarming, and one of the reasons why, as explained elsewhere in this issue, I've written to the Government proposing changes to how pension death benefits are dealt with.

Summarising the survey findings, outside of the questions on death benefits, I'd say that the answers gave me some comfort. We'll have to wait at least a decade before we really see how the pension freedoms pan out. However, I think the majority of those utilising them are doing so sensibly, and we should learn a lesson that policy design based largely on a fear that a small minority will make poor decisions is the wrong way to do it. People may be more rational than we give them credit for.

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