

CLIENT MEMORANDUM

PENSIONS AND THE TAX RULES: THE LATEST CHANGES

This Memorandum covers the simplified tax regime for pension schemes in the UK which commenced on 6 April 2006 (A Day). It provides an explanation of the legislation contained in the Finance Acts 2004 and 2005 and the proposals in the Finance Bill 2006, and draws the attention of clients to options still available to them after A Day.

THE MAIN PROVISIONS

From A Day there is one tax regime for all pension schemes covering tax reliefs, investments and benefits, which allows full concurrency for different employments, with one single consistent set of rules. The regime encompasses both money purchase and final salary pension schemes.

LIFETIME ALLOWANCE

Tax relief in relation to a pension scheme, so far as any member is concerned, is restricted to a lifetime capital value limit of £1.5 million in 2006/07 rising to £1.6 million in 2007/08, £1.65 million in 2008/09, £1.75 million in 2009/10 and £1.8 million in 2010/11. Thereafter the lifetime allowance will be reviewed every 5 years. These limits are tested when members draw benefits. Any excess value above the lifetime allowance is taxed at 25% and any pension is liable to tax under PAYE. If the excess is taken as a lump sum, the tax charge is 55%.

ANNUAL ALLOWANCE

There is an annual limit on the increase in value of a member's fund including contributions. This annual allowance is £215,000 for 2006/07 set on the increase in value of a member's fund in a final salary scheme including member's/employer's contributions, and in a money purchase scheme on member's/employer's contributions only. Members with earnings in excess of the annual allowance will be able to make contributions in excess of the annual allowance to all schemes of which they are a member in total up to 100% of their earnings if their earnings exceed that limit and obtain tax relief thereon. Members' contributions in excess of 100% of earnings do not attract tax relief and if they also exceed the annual allowance the excess over the annual allowance is subject to a tax charge of 40% payable by the member. The annual allowance increases to £225,000 in 2007/08, £235,000 in 2008/09, £245,000 in 2009/10 and £255,000 in 2010/11. Thereafter the annual allowance will be reviewed every 5 years. Earnings on which contributions may be based are from employment income and self-employed earnings in the UK. This includes share options treated as employment income and the earnings of directors from and members of their families who are employees of private investment companies. Employers' contributions on behalf of employees are allowable as deductions for tax purposes in accordance with the general rules for deductions against profits. They are not allowable as deductions if they exceed the annual allowance

BENEFITS

The payment of retirement benefits is allowed from age 50 from A Day, but this will be changed to age 55 in 2010. The income draw-down facility, now known as *unsecured pension*, is available from all money purchase pension schemes from age 50 (55 in 2010) together with phasing. Members with normal retirement ages below age 50 agreed under the pension regime prior to A Day, eg entertainers, sportspersons, may retain them subject to a reduced lifetime allowance. All members can contribute in respect of two or more concurrent employments. They can also take retirement benefits from age 50 (55 in 2010) including an *unsecured pension* and remain in the same employment.

Cash lump sums may be paid on retirement up to 25% of the value of the fund (£375,000 on the lifetime limit of £1.5M in 2006/07) and are tax-free. However, care is necessary where cash lump sums are recycled as further contributions as there are proposals in the Finance Bill 2006 to impose a tax charge where lump sums are used to fund further tax-relieved pension contributions. The proposals cover contributions to pension schemes at the time a tax-free cash lump sum is paid that are significantly greater than they would be otherwise – defined as greater than 30% of the relevant cash lump sum. If these circumstances are met, the whole of the cash lump sum benefit could be liable to a tax charge of 40%. The proposals will not apply where the cash lump sum does not exceed 1% of the standard lifetime allowance (£15,000 in 2006/07).

On death the whole of a member's fund from any type of pension scheme may be paid as a lump sum free from Inheritance Tax if benefits have not been taken or the whole fund used to pay a smaller cash lump sum and survivors' pensions. If death occurs whilst an *unsecured pension* is paid, any cash lump sum paid from the fund

supporting the *unsecured pension* is liable to a 35% tax charge. Survivors' pensions could also be paid or annuities purchased.

Where pension schemes provide the appropriate security of income, pensions may continue to be paid from the scheme for life, eg large self-administered and wholly insured pension schemes. The age 75 restriction on purchasing an annuity for other schemes, e.g. SSAS and SIPPS, remains, but they may pay an *unsecured pension* up to age 75 by which age it must be secured. An alternative to providing a secured pension is an *alternatively secured pension*. This can be paid from the member's fund without the need to purchase an annuity by age 75. However, no lump sum death benefits can be paid, only dependents' pensions, and where a member dies after age 75 it is proposed that the value of the fund will be liable to Inheritance Tax at 40% unless it is paid to a charity.

INVESTMENTS

There is one common investment regime for all schemes from A Day. The income and capital gains arising from scheme investments is not liable to tax. All types of self-administered schemes can invest in the same areas, but with some exceptions. For instance, loans to and unquoted shares in the sponsoring company are restricted to 50% and 5% of the value of the fund for small and large self-administered schemes respectively. Investment in residential property is permitted, but there are proposals carrying severe taxation implications for such investments by SSAS and SIPPS. Additionally, if a member of any self-administered scheme occupies a property owned by the pension scheme at less than a commercial rent, a tax charge is payable by the member at 40% on the value of the benefit in kind obtained regardless of their effective rate of tax.

TRANSITIONAL ARRANGEMENTS

There are transitional arrangements for members of schemes who had pension savings prior to A Day in excess of the lifetime allowance to ensure they are not penalised. These protect members from the tax recovery charge in respect of funds accrued prior to A Day. *Primary protection* is available where the capital value of all of a member's benefits accrued prior to A Day exceed the lifetime allowance of £1.5 million. Any increase in their value at the date of vesting up to the amount of the standard lifetime allowance at that date is protected from the recovery charge. *Enhanced protection* is available to protect fully the capital value of all of a member's benefits accrued prior to A Day regardless of their aggregate value at A Day or at the date of vesting. However, this option is subject to the member ceasing all pension contributions to and benefit accrual in all pension schemes from A Day. Members have until 5 April 2009 to register for *primary or enhanced protection* against the tax recovery charge. This also protects any tax-free cash lump sum entitlement arising before A Day of more than £375,000 or 25% of the value of the fund. *Primary protection* enables the protected tax-free cash lump sum to increase in line with the increase in the standard lifetime allowance up to the vesting date. *Enhanced protection* protects the full value of the tax-free cash lump sum, i.e. it increases in proportion to the increase in the value of the member's fund.

TRANSFERS

Transfer rights may be transferred between registered pension schemes without restriction and without triggering a test against the lifetime allowance, but this should be considered carefully as the right to a protected tax-free cash entitlement could be lost if a transfer is made. Transfers to recognised overseas schemes are allowed, but are treated as a vesting event for testing against the lifetime allowance. Transfers of pensions already in payment from a life office may be made to another life office. Transfers to non-registered UK pension schemes, eg to a FURBS, are not allowed.

CLIENT ACTION

Even though the simplified tax regime for pension schemes commenced on 6 April 2006, it is still possible for corporate clients with occupational pension schemes and individual clients who are members of any type of pension scheme to consider along with their tax, actuarial and financial advisers, the effect of the pensions regime on themselves, the options still available, and what, if anything, they should do. For individuals, whether they are within a few months of drawing benefits or still have years to go, there are still new opportunities to plan for retirement. The following points, which are not exhaustive, are intended to alert clients to where they can still act.

Companies should consider reducing the number of their pension arrangements particularly as they can now hold the same investments. It is possible to “ earmark ” particular investments for individual members. Alternatively, it is possible for a company to have more than one SSAS.

Companies should consider cash as an alternative reward to pensions benefits for directors and high earners. Such persons have new options available to them for making pensions savings close to retirement to maximise the tax advantages. For instance, in the year in which an individual takes all their retirement benefits, contributions in excess of the annual allowance are permitted with full tax relief on those contributions. Alternatively, directors could pay themselves high salaries in some years and not in others and then pay it all into a pension scheme and obtain tax relief on 100% of those high earnings.

Private investment and property investment companies should consider establishing an occupational or personal pension scheme for their directors and members of their families who have earnings from such companies as these earnings may now be pensioned in full.

Companies, partnerships and sole traders should consider the relaxations in the ownership of property and on transactions with connected persons. SSAS, SIPPS and retirement annuity contracts can buy property from and sell it to members; lease property to members and to partnerships of which the members are partners; and own property jointly with members and partnerships of which the members are partners.

A sole trader with no pension arrangements, or who is a member of a retirement annuity contract or personal pension scheme, should consider establishing a pension scheme with themselves as a member in respect of their self-employed earnings together with their employees and their spouse. Or they may become a member of the current pension scheme of their employees.

The options for *primary or enhanced protection* are available for members until 5 April 2009. Opting for *primary protection* before then does not prejudice the position of a member's pension rights since A Day, but opting for *enhanced protection* can, if contributions have been paid between A Day and the date of opting, or additional pensionable service has accrued. If *enhanced protection* is an option, a member should ensure no contributions are paid and no further benefits accrue before they register for enhanced protection. Such considerations similarly apply where *enhanced protection* is being considered for cash lump sums only.

Members of all pension schemes with retirement ages below 50 agreed before A Day, who would from 2010 onwards have been able to draw their retirement benefits from say age 40, but will be unable to do so instead until age 55, or who only may be able to do so with a 2.5%pa reduction to the lifetime allowance, ought to consider whether the *primary or enhanced protection* options would be more beneficial.

Members contemplating taking a tax-free cash lump sum benefit and making a contribution to a pension scheme at the same time, i.e recycling, should consider very carefully the amounts involved. They should ensure that any contributions are not significantly greater than previously, i.e they do not exceed 30% of the cash lump sum.

Members who have deferred taking a tax-free cash lump sum until after A Day because they did not want to infringe the former early retirement rules by continuing to work for their employer, should also seek advice on whether or not they will be caught by the recycling proposals should further contributions be paid to any current pension scheme.

Transfers of pension rights which were precluded under the previous pension regime, i.e. for directors and high earners from occupational to personal pension schemes, may now proceed unless it would still be beneficial to remain a member of that scheme. In addition, where members have rights under the current regime which did not exist before A Day, e.g. rights to an *unsecured pension* in a retirement annuity contract, they should consider whether to remain or to transfer their benefits.

FOR GENERAL INFORMATION ONLY

The information given in this Memorandum is based upon our current understanding of HM Revenue and Customs legislation. We would emphasise that the Finance Bill 2006 together with various statutory instruments deriving from it, with further details of the common tax regime for pension schemes, have still to become law and therefore may be subject to change. Please also note that this Memorandum is not intended to give specific technical advice and it should not be construed as doing so. It is designed merely to alert clients to some of the issues. It is not intended to give exhaustive coverage of the topics.

Professional advice should always be sought before action is either taken or refrained from as a result of information contained herein.