Bulletin

# Pensions
## the new regime

***Proposals for the radical simplification of the taxation of pensions were originally announced in December 2002 and initially intended to take effect from April 2004. Following representations from the pensions industry, the start date has now been delayed until April 2006 (referred to as 'A-day').***

***In this bulletin we focus on the way in which the new regime will operate to allow tax relief on contributions into a pension fund and how monies can be extracted in retirement. Although the new regime is a simplification this does not mean that pensions will become simple! Some reference is required to the terminology used in pension provision and a glossary of the terms used is set out on the back page of this bulletin***

### What is planned?

The plan is to scrap the existing eight tax regimes for pensions and replace them with a single set of rules. Currently there are anomalies between the different types of schemes.

For example, under a modern defined benefit scheme, employees may contribute, with tax relief, up to 15% of earnings up to the earnings cap (£102,000 for 2004/05). Under a modern personal pension plan, individuals may receive tax relief on contributions up to the higher of £3,600 a year or a percentage of capped earnings, the percentage varying according to age.

Furthermore the regimes have different rules regarding what benefits can be paid out to members. Members in a modern defined benefit scheme are limited to two thirds of final earnings (up to the cap) after 20 years' service but there are no limits on the size of pension benefits for those with personal pensions. There are also different rules governing the amount of tax-free lump sums that different schemes can pay.

### Key controls in the new regime

Under the new regime, there will be two key controls for all schemes namely:

- the annual allowance; and
- the lifetime allowance.

Other key features of the new regime will be that:

- it will no longer be necessary to leave employment to access an employer provided pension scheme;
- it will no longer be necessary for employees to choose between membership of a personal pension and an employer provided pension scheme - they will be able to join any type and any number of pension schemes at any time.

### Registration

There will still be different types of pension schemes available and these schemes will still need to register under the new regime to benefit from privileged tax treatment, ie exemption from tax on income and gains within the fund and eligibility for tax relief on contributions to the fund.

Any scheme that is already registered when the new rules are introduced will be treated as registered under the new regime.

### Relief for individuals' contributions

Under the new regime, there will be no restriction on the amount of contributions an individual can pay into a registered scheme; only on the amount of tax relief given. This means that unlimited contributions may be made to, and retained by, a registered pension scheme.

Investment income build-up and capital gains will accrue tax-free within the fund.

An individual will be entitled to tax relief on personal contributions in any given tax year up to the higher of 100% of 'relevant UK earnings' or £3,600.

Relevant UK earnings means (broadly) employment income and/or trading profits (for the self employed).

Tax relief on contributions will continue at the individual's marginal rate of tax. The main way relief is given will be similar to the way relief is given currently to personal pension scheme contributions ie by the basic rate of tax relief being given at source, with higher rate relief claimed through the self assessment tax or PAYE systems.

## Employer contributions

Under the new regime there will be the same rules for any type of scheme allowing tax deductions to the employer in respect of employer contributions to a registered pension scheme. This is subject to the contributions actually being paid in the period, a spreading of tax relief for very large payments (over £500,000) and the payment being made 'wholly and exclusively' for the purposes of the trade.

This will give people who run their own companies considerable flexibility in deciding when to make payments into a pension fund and whether the payments should be made by the company (ie the employer) or the individual.

**Example**

Eric is self employed. His profits for 2006/07 are £60,000. He pays a monthly pension contribution of £780 net into a personal pension scheme.

Each £780 is a payment net of basic rate tax relief at source of £220, so the 'gross' contribution would be £1,000 without any tax relief. The total gross payments in the tax year are £12,000 and, as this is less than his profits, he is entitled to tax relief at his marginal rate of tax. His marginal rate of tax on the top £12,000 of income is 40%. As he has been given basic rate tax relief at source (22%), the extra relief (18%) will need to be claimed through his tax return.

If Eric's profits fall to £20,000 in the following year, 2007/08, and he continues to make the same monthly payments, he will still be entitled to tax relief, as the gross contributions are less than his profits. So he will obtain basic rate relief at source (22%). He is not a higher rate taxpayer in this year, so there is no further relief due.

Due to the need to 'simplify' the tax relief rules, some flexible features of the current regime for personal pensions will disappear. In particular there will be no facility to carry back contributions to an earlier tax year. So Eric, under the current system, could have claimed to carry back some of the contributions paid in 2007/08 to 2006/07 and thus obtain higher rate tax relief. But he cannot do so under the new regime.

Nor will the 'six year cycle' continue. This, currently, is the ability to nominate earnings from a previous tax year as the earnings figure against which tax relief is measured.

In other words the maximum contributions for which tax relief will be given will be determined by reference to earnings in the tax year of payment only.

The reason for having a 'light touch' approach to tax relief for employer contributions is that there are key controls for all schemes in the annual allowance and the lifetime allowance. The effect of these will limit the amount of tax efficient contributions that may be made.

## What is the annual allowance?

The annual allowance provides for the annual increase in an individual's rights under all registered pension schemes to be calculated. This is then compared with the annual allowance and any excess charged to income tax at 40%.

For 2006/07 the annual allowance will be set at £215,000. Figures for subsequent years are not yet set but it will rise to at least £255,000 by 2010. The level will then be reviewed every five years.

The annual increase in rights is calculated differently according to the type of scheme. For a money purchase scheme the increase will be the total of contributions made in the year by the individual and any employer. For defined benefit schemes the increase calculation is complex. Broadly it will be the difference between the value of the rights at the beginning and end of the year with the opening values uprated by inflation.

In order to lessen the effect of the annual allowance when someone is close to retirement, it will not be applied in any year in which the benefit is taken in full.

**Example of employee and employer contributions**

Jo is a shareholder/director in his family company. He draws an annual salary of £5,000 and takes significant dividends out of the company. He has a personal pension.

Under the new regime, in 2006/07 Jo would be able to pay an annual contribution of £5,000 (gross) (with tax relief) into his fund. More could be paid but there would be no tax relief for Jo.

The company could make unlimited contributions and obtain corporation tax relief but to the extent they exceed £210,000 (ie £215,000 annual allowance less the £5,000 Jo has paid) Jo will suffer a 40% tax charge on the excess.

However, it is clear that the company will be able to fund very significant contributions without the need for any link to Jo's salary and without creating a tax charge on Jo.

## What is the lifetime allowance?

The second key control under the new regime will be the lifetime allowance.

Although individuals can save as much as they like in registered schemes under the new regime, when they start to draw benefits (a 'benefit crystallisation event') the value of their fund will be tested against the lifetime allowance and any excess subject to the lifetime allowance charge.

There are eight different benefit crystallisation events. They cover, for example, the different ways an individual can begin to take a pension or the receipt of a lump sum in connection with a pension. As it will be possible to draw benefits in stages, for example, taking a pension on part of the pension fund and taking a pension in the remaining fund later, the calculations may be complex.

However on the first benefit crystallisation event the calculation will be relatively straightforward; a comparison will be made between the value being attributed to the event and the then lifetime allowance.

After much debate, the lifetime allowance has been set as follows: at £1.5 million for 2006/07 rising to £1.8 million for 2010/11. Thereafter the limit will be reviewed every five years.

The lifetime allowance charge on the balance of funds in excess of the lifetime allowance has been set at 25% with the balance of the fund being taken as a pension. There is an alternative of taking any excess as a lump sum but with a recovery charge of 55%.

**Example of the lifetime allowance being breached**

Sam has a pension fund valued at £2 million when the lifetime allowance is £1.5 million and he starts to draw benefits.

The fund up to £1.5 million can be used as a maximum tax-free lump sum of £375,000 (25%) and the balance used to buy a pension.

The excess of £500,000 is subject to a 25% lifetime allowance charge. The scheme will pay a £125,000 recovery charge to the Inland Revenue. The balance of £375,000 will be available to buy a pension.

Alternatively the recovery charge is 55% if Sam chooses to take the excess as a lump sum. The scheme will pay a £275,000 recovery charge to the Inland Revenue. Sam will receive the balance of £225,000 with no more tax to pay.

Although at first sight the 25% charge appears far better than the 55% charge, the charge at 25% may ultimately give rise to a maximum effective tax rate of 55% as well, since the 75% of the excess remaining in the fund will be used to buy a pension which may be taxed at 40%.

## Protection from the lifetime allowance charge for current pension funds

In principle all the existing eight tax regimes for pensions come into the new regime on A-day. But if an individual's pension fund is currently near to or already above the lifetime allowance, it will be possible to have some or complete protection from the lifetime allowance charge.

Two types of protection will be available.

**Primary protection**

Protection will be given to the value of pre A-day pension rights and benefits in excess of £1.5 million. The pre A-day value will be indexed in line with the indexation of the statutory lifetime allowance up to the date that benefits are taken.

**Enhanced protection**

This is available whatever the value of the fund so long as active membership of approved pension schemes ceases before A-day ie contributions are not made to any pension scheme after A-day. All benefits coming into payment after A-day will then normally be exempt from the lifetime allowance charge.

Enhanced protection is likely to be beneficial for those with funds in excess of £1.5 million by April 2006 and for those with funds below that level but who expect investment growth well above inflation.

**Example**

| | Primary protection | Enhanced protection |
|---|---|---|
| Fund at A-day | £2,000,000 | £2,000,000 |
| Fund at retirement | £3,000,000 | £3,000,000 |
| Revalued A-day fund after increase in line with lifetime allowance - say | £2,600,000 | N/A |
| Excess subject to lifetime allowance tax charge at 25%/55% | £400,000 | Nil |

## Pension age

The minimum age for taking benefits will rise from 50 to 55 by 2010. Schemes will be free to decide how to move to this new minimum age. Early retirement because of ill health will continue to be allowed.

## Scheme benefits

Under the new regime, up to 25% of the pension fund, below the lifetime allowance, can be paid as a tax-free lump sum. For many people, particularly those in schemes where the lump sum is currently capped, this represents a significant increase.

**The age 75 rule**

Subject to the lump sum, the balance of the fund must be secured by age 75 by taking a pension eg an annuity guaranteed by an insurance company or a pension from an employer. There will also be the facility to retain some control of the fund by taking 'alternatively secured income' (ASI).

Under ASI:

- the annual pension income must be between minimum (expected to be £1) and maximum limits
- the maximum will be 70% of the annual amount which would be payable if the fund were used to buy a flat-rate single-life annuity on the open market for a person aged 75.

At present, it is not clear whether this option will be attractive to many people.

If death occurs before pension benefits are taken, the fund can be paid to dependants as a lump sum subject to the lifetime allowance charge, if relevant, or as pension income subject to income tax.

No capital may be returned if death occurs on or after age 75. This is a feature of our current regime. The firm view of the government is that tax relief for pension contributions and the fund is given to enable a pension to be provided in retirement. It is not given in order to provide a tax efficient mechanism of passing wealth to the next generation.

## Taking benefits before 75

There is no compulsion to take any benefits before age 75 but the vast majority of people will need to draw income before that age. If a person does not wish to take an annuity, benefits may be taken as 'unsecured income'. This is similar to the 'income drawdown' facility currently available.

From A-day, the rules for unsecured income before age 75 are:

- annual pension income must be within minimum and maximum limits;
- the minimum is £1;
- the maximum in any year is 120% of the annual income payable if the pension fund were used to buy a single-life flat-rate annuity on the open market.

**Example of unsecured income**

Ash, after taking his tax free lump sum on 6 April 2007 at age 60, has a pension fund valued at £350,000 from which he intends to take unsecured income. For that sum of money on the open market he could have purchased a single-life flat-rate annuity of £22,000 a year. Ash must take a minimum of £1 a year but no more than £26,400 a year (120% of £22,000) until 5 April 2012.

Ash varies the income he takes each year within these limits and at 5 April 2012 the remaining fund is valued at £400,000. Ash is now 65 and the fund would be able to purchase a single-life flat-rate annuity of £28,000 a year for him on the open market.

Until the income is next reviewed (no later than 5 April 2017) Ash may take income from the unsecured fund of between £1 a year and £33,600 a year (120% of £28,000).

## Glossary of terms

**Defined benefit schemes**

In a defined benefit scheme, the pension you receive will be based on a fraction of your pensionable earnings (those taken into account by the scheme) at retirement. The size of the fraction is calculated by reference to the length of your service. Commonly used fractions are 1/60th or 1/80th for each year of service. For example, anybody in a scheme based on sixtieths between the ages of 25 and 65 (40 years of service) would be entitled to a pension of 40/60ths or 2/3rds of their final salary (this is the maximum permissible).

**Money purchase schemes**

A money purchase scheme does not guarantee a set level of pension to you when you retire. Instead, the benefits you will receive are based on the amount of money contributed to the pension fund and the investment performance of the assets into which it is placed. All personal pension plans are money purchase schemes. Many employer provided pension plans are also now money purchase schemes.

On retirement a portion of your fund can be taken as a tax-free lump sum (within permitted limits) and the remainder is used to buy a pension for the rest of your life - an annuity. You may decide if you want to use up part of your fund to give yourself regular increases and/or provide for a pension for your spouse should you die first.

**Earnings cap**

The maximum earnings on which the pension from an employer provided scheme and contributions to personal pensions can be based is called the 'earnings cap'. A new earnings cap is announced each year in the Budget and implemented at the start of the following tax year.

**Personal pension**

If you're an employee and are not a member of an employer provided pension scheme or are self employed you may choose to set up a personal pension plan. You can choose what sort of investment you want from those on offer. Personal pension plans always operate as money purchase schemes.

**Income drawdown**

Income drawdown is one option for putting off purchasing an annuity until you reach age 75. Any income you take out of your fund is taxable. The Inland Revenue limits the maximum income through income drawdown to broadly the same as a level annuity for a single person of your age and sex (single-life flat-rate annuity). The minimum income you may take is 35% of the maximum.

Clearly the pension regime is complex and even the new simplified regime can leave you confused at times! Please talk to us if you have any questions on the issues we have covered in this bulletin.

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