

Making pensions simple

This is the first in a series of our briefing cards, which cover the Inland Revenue's rules on pensions reform, Morgan Fitzgerald's views on those rules and what they will mean for you and your customers. This first briefing card gives a high level summary of all the main provisions as outlined in the Finance Act 2004. Regulations will be published through forthcoming Statutory Instruments.

We also have briefing cards covering six main topics: Just ask.

The lifetime allowance charge

Contributions

Tax relief and the annual allowance

Taking income Death benefits

Transitional protection – Pension rights Transitional protection – Tax-free cash

Money purchase schemes and the Scheme Pension

Setting the scene

The March 2004 Budget confirmed that proposals for Pensions Simplification would go ahead. From 6 April 2006 there will be one set of tax rules for all types of pension, with an individual Lifetime Allowance of £1.5 million for all. The Annual Allowance will be £215,000 for the tax year 2006/07. Morgan Fitzgerald fully supports the move to a single set of tax rules, which will make pensions much simpler for most of our customers. We see a number of key advantages for our customers in the new regime:

- Pensions will be much easier to understand.
- Most customers will have greater flexibility in the size and timing of their contributions.
- In many cases, there will be no need to make contribution checks, which will mean simpler, and even better processes and service.

The Lifetime Allowance

The main feature of the simplified regime is a single Lifetime Allowance for everyone. This is the new limit to the amount of pension savings (including contracted-out benefits) anyone can take in their lifetime without tax penalty. The Lifetime Allowance will be £1.5 million initially and will increase to £1.6m in 2007/08, £1.65m in 2008/09, £1.75m in 2009/10 and £1.8m in 2010/11 and then it will be reviewed every five years.

The value placed on benefits when tested against the Lifetime Allowance is known as the "Crystallised Value".

- For money purchase schemes, this will normally be the fund value.
- Benefits from a defined benefit scheme, or a Scheme Pension paid from a money purchase arrangement will be calculated at £20 for each £1 of pension (20:1). This assumes the pension grows by no more than the greater of the increase in the Retail Prices Index (RPI) and 5%, and includes dependants' pensions of no more than the member's pension.

- For benefits already in payment prior to A-day, a factor of 25:1 will be used to reflect the fact that most people would have taken tax-free cash; drawdown arrangements will apply this factor to the maximum income available.

The Lifetime Allowance Charge

The Lifetime Allowance Charge is the tax charge on funds above the Lifetime Allowance or any protected amount. It is:

- 55% if the excess is taken as a lump sum
- 25% if the excess is taken as income. This income is then taxed under PAYE (which works out at an effective charge of 55% for higher-rate taxpayers).

The Annual Allowance

From April 2006 total payments to pension schemes each year will, in theory, be unlimited. However for both individual and total payments there are limits on tax relief. The Annual Allowance for individual payments, which will attract tax relief is £3,600 or 100% of earnings, whichever is higher. The Annual Allowance for total payments, which will attract tax relief is £215,000 in 2006/07 and will increase by £10,000 each year to reach £255,000 in 2010/11. We expect the Annual Allowance to be reviewed every five years.

The Annual Allowance will apply to payments to money purchase schemes and increases in the value of defined benefit schemes. Payments made in the year before the individual takes their full benefits do not count towards the allowance. This will help some employees who receive an enhancement of pension rights in cases of redundancy, ill health or early retirement that may otherwise have been penalised. Under defined benefit schemes, each £1 of pension increase will be counted as £10 of payment. Therefore annual benefit increases of more than £21,500 in a defined benefit scheme will be caught. There are some payments that do not count:

- Individual payments in excess of 100% of earnings (as no tax relief is given).
- Age-related rebates to contracted-out money purchase and personal pension schemes.
- A recognised transfer, i.e. from another registered UK scheme or an overseas scheme recognised as a pension scheme.
- AVCs used to buy added years (though the increase in the value of the pension rights will be measured).
- A pension credit granted on a divorce, except where it is in respect of a non-registered scheme.
- Payments made to a non-registered scheme.
- Payments made in the year before individual takes full benefits.

Contributions and tax relief

Relevant UK individuals who are active members of registered pension schemes will be entitled to tax relief. An individual is a relevant UK individual for a particular tax year if they are under 75 and:

- (a) They have relevant UK earnings chargeable to income tax for that year; or,
- (b) They are resident in the UK at some time during that year; or,
- (c) They were resident in the UK both when they became a member of the pension scheme and at some time during the previous five tax years; or,
- (d) They or their spouse have, for the tax year, earnings from overseas Crown employment subject to UK tax.

Unlimited contributions can be made, but tax relief will be limited to the highest of £3,600 and 100% of earnings. Tax relief on an employer contribution is unlimited in most cases. Where contributions exceed the Annual Allowance the excess will be taxed at 40%.

Pension age

The minimum age for taking benefits will increase from age 50 to age 55 by 2010, with pension schemes free to decide how to make this change. Benefits must be secured in some form by age 75. Members of existing occupational schemes and people with personal pensions/retirement annuities with special occupations (professional sportspeople) will have some protection to take benefits before age 55. A reduction of 2.5% for each year before normal minimum pension age will be made to the Lifetime Allowance. This reduction will not apply to those in the current armed forces, police and fire services pension schemes. New schemes for these professions (which will adopt the age 55 rule) are expected to be in place before 2010.

Form of retirement benefit

Up to 25% of a pension fund (up to the Lifetime Allowance) can be taken as tax-free cash. This will allow schemes that currently do not provide cash, (e.g. free standing AVC schemes) to do so. The Department for Work and Pensions (DWP) has recently confirmed they intend to allow tax-free cash of 25% to be paid from protected rights monies at retirement. This should be confirmed when the Pensions Bill is passed. The remaining fund must be used to provide an income in one of the following ways:

- Secured benefits - a guaranteed income (annuity purchase or Scheme Pension).
- Unsecured benefits – a non-guaranteed income prior to age 75 (income drawdown).
- Alternatively secured pension – this option will be available to everyone from age 75.

The maximum income from unsecured benefits is equal to 120% of the annual income available from a level, single-life annuity on the open market. It must be reviewed at least every five years. There is no minimum. Part of the designated drawdown fund can also be used to purchase a short-term annuity (not exceeding 5 years). An alternatively secured pension (post 75) will be subject to a maximum of 70% of the amount available on the open market always based on age 75, with no minimum, and will be reviewed annually.

Trivial commutation

Individuals will be able to exchange small pension funds where they do not exceed 1% of the Lifetime Allowance (initially £15,000). The total of all vested and unvested pension funds must be less than 1% of the Lifetime Allowance for this to be available and it must be done within a single 12-month period between the member's 60th and 75th birthdays. Up to 25% of the fund can be taken as tax-free cash with the remaining fund taxed as income.

Ill health

All schemes can provide benefits early on incapacity. Where the member's expectation of life is less than one year, pension benefits can be fully exchanged for cash, with no income tax liability provided they are within the Lifetime Allowance.

Death benefits

Lump sum death benefits of up to the Lifetime Allowance will be paid free of tax where no benefits have been taken. Where the Lifetime Allowance is exceeded, there will be a tax charge of 55% on the excess fund where this is taken as a lump sum. Where the excess is paid as a pension to dependants, there will be no recovery tax. The scheme pays out lump sum death benefits without any deduction, and it is the recipient's responsibility to settle any tax liability.

When death occurs during drawdown (unsecured) the whole of the remaining fund can be paid out less 35% tax, or the whole fund can be used to provide dependants' pensions, either via an annuity or continuing drawdown. The death benefits from an annuity that gives value protection (before age 75) will be calculated as the purchase price, less installments, less 35% tax.

Pensions and divorce

The crucial point is whether the pension sharing order was created before or after A-day. For pension sharing orders in place at A-day, when calculating the value of a member's pre A-day pension rights, the value of any pension allocated to a spouse on divorce will be ignored for the purposes of both spouses' Lifetime Allowances. Pension credits created after A-day will count against the ex-spouse's Lifetime Allowance (unless derived from a pension in payment), as it will already have been tested against the member's Lifetime Allowance.

Investment

After A-day all pension schemes will be able to invest in all types of assets, including residential property. Any non-commercial use of an asset (for example, where the member lives rent free in a house owned by the pension scheme) will be regarded as a benefit in kind on the member and taxed accordingly. Holdings of shares in the sponsoring employer will be restricted to 5% of the fund value. Loans of up to 50% of the asset value can be made but only to employers. Investments made before A-day will not be affected by these changes. Scheme borrowing will be restricted to 50% of the scheme's assets, subject to DWP requirements (which may be more restrictive). There will no longer be an Inland Revenue requirement for a pensioner trustee.

Unapproved schemes

Funded and Unfunded Unapproved Retirement Benefit Schemes (FURBS and UURBS) will be known as Employer-Financed Retirement Benefits Schemes in the new regime. Tax treatment for those schemes will be:

- Employer payments will not be taxable or subject to National Insurance at the time of payment.
- No tax relief on employer contributions until benefits start to be paid.
- Benefits will be subject to income tax.

FURBS and UURBS in existence at A-day will have some transitional protection:

- Where an employee has paid tax on their employer's contributions to a FURBS, contributions can continue to be made and an adjustment will be made to the tax-free element of any lump sum benefit finally paid out.
- An existing UURBS may be rolled into a registered scheme within 3 months of A-day without affecting the Annual Allowance. Schemes currently approved will be able to opt out of the new regime at A-day and become unregistered. There will be a 40% tax charge on the assets immediately before opting out and benefits taken will be liable to tax and National Insurance.

Tax and legislation are liable to change. This information is based on our current understanding of Law and Inland Revenue practice and the legislation we believe will apply from 6 April 2006. Tax relief's may also be altered and their value to the investor depends on their financial circumstances.