The Actuarial Profession
making financial sense of the future

Pensions Conference 2011 - Moving ahead of the curve
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C5: The new pensions tax regime
Issues for actuaries

Agenda

- Annual Allowance reduced to £50,000 from 6 April 2011
- Focus on defined benefit

State of play of legislation

This session is based on the

- Finance Bill 2011 published 29 March 2011 with government amendments 18 May
- draft regulations issued up to 27 May
- material issued by HMRC up to 27 May
  - including correspondence on http://www.aca.org.uk/aca-briefing_papers.html.

Savings in excess of the £50,000 annual allowance

Employer contributions

Corporation tax relief
National Insurance free

Employee contributions

Full income tax relief

Annual Allowance charge

25% tax-free lump sum

Pension, subject to income tax

Investment return mostly tax free

Overview: old AA to new AA

- Meaningful tax measure now:
  - scrutiny of the definition of accrual
  - old elements have new importance (PIP, arrangement)
  - new rules to assess "year of drawing benefit"
- Tax upfront, so for large bills:
  - "Scheme Pays"
- Member managing the tax through Self Assessment:
  - schemes to identify many of those caught
  - employer/schemes to provide information, but member brings it all together
- Scheme redesign.

Where are we?

- All current active members are now using up either
  - Annual Allowance for the tax year 2011/12 and may have been doing so since [14 October 2010]
  - Annual Allowance for the tax year 2012/13
- The Finance Bill will be enacted around mid July
- The legislation is still very much on the move:
  - key change to "Year of retirement" on 31 March and then on 18 May
  - key AA draft regulations published end May.

DB calculation against the 2011/12 AA Member accruing in a 1/60th scheme

£160,000 x 24/60 = £64,000 pa

+3.1% (**CPI** 2011/12)

= £65,984 pa

£168,000 x 25/60

= £70,000 pa

£4,016 X **16** = £64,256

£4,016 pa

First £50,000 = No tax

Excess £14,256 taxed at 50% =

NEW TAX **£7,128**

but check carry forward

The member draws benefits: changes to the Bill proposed 18 May 2011

£160,000 x 24/60 = £64,000 pa

+3.1% (**CPI** 2011/12)

= £65,984 pa

£168,000 x 25/60 = £70,000 but x 0.96 for early payment

= £67,200 pa

£1,216 X **16** = £19,456

1,216 pa

Does not exceed £50,000

NO NEW TAX

The member draws benefits

- Actual pension, with any commutation unwound
  - if "lump sum plus post-commutation pension" used:
  - a member commutes at say £18 per £1pa
  - commutes £10,000 pa of the pension
  - £160,000 value would become £180,000 value
  - the act of commuting would use £20,000 of AA.
- "Actual pension" on late retirement?
  - 16 March 2011 guidance (see ACA website) - still extant

Pension Input Amount used up in 2011/12: is this calculation right?

- A scheme's rules promise 2/3rds on retiring from service at NRA and N/NS x 2/3 on earlier leaving, reduced if immediate retirement

	Member in year 19 in 2011/12, of potentially 40	
Start	19/40 x 2/3 x 115,000	= 36,417
End	20/40 x 2/3 x 120,000	= 40,000
PIA	(40,000 - 1.031 x 36,417) x 16	= £39,265

Operation of valuation assumptions N/NS x 2/3

	What you might expect	What HMRC say the law says and should say
	2011/12: member with 19 years of 40	
Start	19/40 x 2/3 x 115,000 = 36,417	2/3 x 115,000 = 76,667
End	20/40 x 2/3 x 120,000 = 40,000	2/3 x 120,000 = 80,000
PIA	£39,265	£15,301

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The basis for the HMRC reading: “the valuation assumptions” in Finance Act 2004

- *“P is the annual rate of the pension which would, on the valuation assumptions … be payable .. if the individual became entitled to payment at [date X]”*
- *The “valuation assumptions in relation to a person, benefits and a date are-*
  - *if the person has not reached such age (if any) as must have been reached to avoid any reduction in the benefits on account of age, that the person reached that age on the date, and*
  - *that the person's right to receive the benefits had not been occasioned by physical or mental impairment.”*

Operation of valuation assumptions N/NS x 2/3

- A scheme’s rules promise 2/3rds on retiring from service at NRA and N/NS x 2/3 on earlier leaving, reduced if immediate retirement

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- The right hand figure could be bigger than the left hand eg a shorter service individual with material pensionable salary rises

Operation of "the valuation assumptions" N/NS x 2/3

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	2011/12: member with 19 years of 40	
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End	20/40 x 2/3 x 120,000 = 40,000	2/3 x 120,000 = 80,000
PIA	£39,265	£15,301
	Joiner in 11/12 with NS 40	
Start	0/40 x 2/3 x 115,000 = £0	0 x 115,000 = £0
End	1/40 x 2/3 x 120,000 = £2,000	2/3 x 120,000 = £80,000
PIA	£32,000	£1,280,000 (few cases..)

Operation of "the valuation assumptions"

- Exact documentation is key
  - side letters
  - the complete rules (continued Inland Revenue limits could be key)
- For a scheme's rules promising

  1/45 x (N limited to 30) on retiring from service at NRA
  and N/NS x NRA fraction, on earlier leaving, reduced if retirement

  the outcome would be different:
  - not "(N+1)/NS – N/NS"
  - but either 1/45 accrual, or 0/45 accrual depending on whether N has reached 30 years.

Assessing the PIA
Position at start/end of Pension Input Period

Opening position may be:	Closing position may be:
Active member notional assumptions	Active member notional valuation assumptions
	Deferred pensioner notional valuation assumptions (but recognising the changed status and facts)
	Pensioner mostly, actual benefits (pre-commutation)
	Mixture
Deferred member notional assumptions	One of the above or Carve-out

Valuation assumptions
and “notional versus actual” are key

- Existing benefits scales and options
  - Temporary (bridge) pensions
  - IR limits
  - Split NPAs
  - Pension increase exchange options at retirement
  - What else?
- Designs to cap benefits.

Example design issue
Bridge pension accruing year by year

£100 pa bridge pension payable for 5 years accrues in the year	
It is "worth"	Less than £500
The Annual Allowance it uses up	£1,600
The AA charge it causes If the member has used up all AA and carry-forward	Up to £800
Net benefit to the member	Minus £300

Example design issue
Bridge pension at early retirement/from option

£6,000 pa bridge pension payable for 5 years arising at retirement, but not in the notional pension	
It is "worth"	Less than £30,000
The Annual Allowance it uses up	£96,000
The AA charge it causes if the member has used up AA and carry-forward	Up to £48,000
And information provision even if not.	

Scheme Pays
Preferred by members to pay the charge?

- Cash flow
- tax effect
  - from gross benefits
  - AA charge payable almost one year later
  - a pension reduction reduces potential LTA charge
  - …but also reduces maximum allowed tax free cash sum
- so qualification rules for “Scheme Pays” are important
- mandatory access must be given if
  - the member has a total AA charge of £2,000+
  - and the scheme’s PIA is £50,000+.

Scheme Pays
Consequential adjustment

- Set by trustees (if an occupational pension scheme)
  - to the *“entitlement of the individual to benefits under the pension scheme”*
  - on a basis that is *“just and reasonable having regard to normal actuarial practice”*
- HMT policy indicated full flexibility
  - but from member pension only?
- administration cost to scheme not a just adjustment
- “Scheme Pays” can be offered “voluntarily”
- Legal advice.

Deferred pension carve-out for DB arrangements

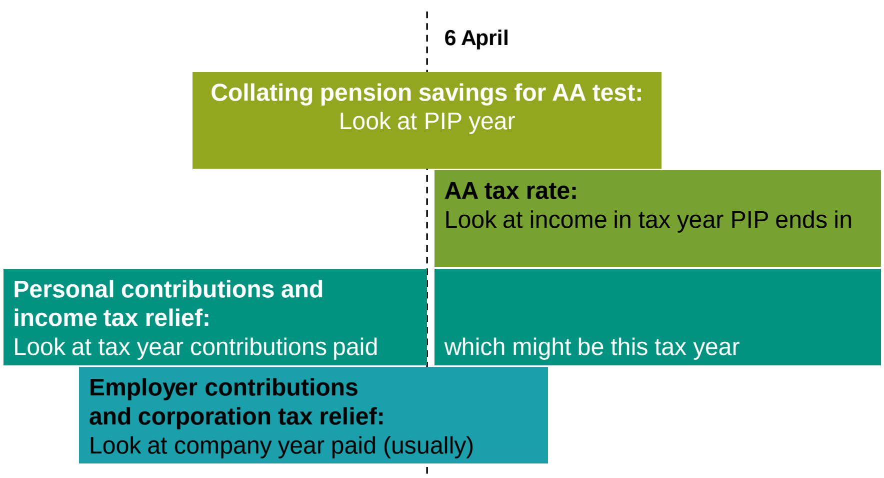
Deferred pensioner carve-out (beware: broad paraphrasing here)

- No AA used up in a PIP by an arrangement if both-
- the individual is a deferred member of the pension scheme throughout the PIP
  - or would be if the individual had only this arrangement in the scheme
- and the value of the relevant rights of the individual does not increase over the PIP by more than the relevant percentage
  - according to a provision for a rate specified in rules 14 October 2010
  - CPI with some flexibility.

Deferred pensioner carve-out
Closures to accrual

Carve-out?	Not possible for salary linking Not if special revaluation solely while an employee Arrangement structure could be key
If no carve-out	Some AA used Creates difficulties in managing future DC Potential CPI mismatches potential for charge information obligations

Relevant time periods
if PIP is not 5 April



Pension Input Periods

- All considerations must reflect PIPs
  - and PIPs work at a member/arrangement level
- Closures/transactions/scheme rearrangements
- Some imminent retirements/Scheme Pays cases need the September 2011 CPI
- Unnominated PIPs - act now – deadline early July
  - a default PIP for a member is left at “7 Aprils to 6 Aprils”
  - if desired later, tax year alignment will be possible;
  - but eg by setting one (interim) PIP of near 24 months.

Questions or comments?

Expressions of individual views by members of the Actuarial Profession and its staff are encouraged.

The views expressed in this presentation are those of the presenter.