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The 2004 Pensions Convention

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Tax simplification: New ideas in scheme design for staff schemes

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Tax simplification: new ideas in pension scheme design

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Tax simplification: new ideas in pension scheme design

Good intentions for this presentation

- Avoid too much focus on the high earners
- Concentrate on positive aspects
- Concentrate on registered schemes based in the UK
- Assume the basics are known

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Tax simplification: new ideas in pension scheme design

Background

- Lifetime allowance £1.5m 2006/07
- Annual allowance £215,000 2006/07
- Both reviewed by Treasury, cannot reduce
- 25% tax-free cash; pension taxed as income
- 20:1 factor for DB vesting at all ages
- 10:1 factor for DB annual accrual (1:1 for cash)
- Recovery charge over LA 25% (55% if lump sum)
- Charge over AA 40% (excl year of vesting/death

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Background

- Maximum relievable member conts greater of £3,600 or 100% of earnings (can pay more, but no relief)
- Employer conts unlimited – current informal practice on spreading relief formalised
- Flexible retirement; minimum age 55 from 2010
- Full concurrency
- Lump sum death benefits can be tax-free within LA
- Dependants' death-in-service pensions outside LA
- Non registered schemes (Employer Financed Retirement Benefit Schemes) – taxed as income to employee when received, no employer tax relief until benefit paid, no IHT relief, NI position unclear

Tax simplification: new ideas in pension scheme design

Agenda for this presentation

- Maximising the advantages
- Implementing the changes
- Transitional issues
- Death benefits
- Dealing with high earners
- Consolidation or proliferation of pensions vehicles

Tax simplification: new ideas in pension scheme design

Maximising the advantages

- Complexity of current rules restrict choice and flexibility for individuals, employers and pension providers alike (Inland Revenue)
- Finance Bill will be of real benefit to 98% of the UK's workforce (PWC)
- Sweeping away of 4 different approved occupational pension scheme regimes
- Protections are available

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Maximising the advantages

- £1.5m will go a long way for the majority of people even if the limits may not keep up with salary increases
- And the limit rises to £1.8m

-But need inflation protection written into the Finance Bill

- Is overfunding so bad – still had tax exemptions and National Insurance gains

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Maximising the advantages

- New range of investments possible though subject to DWP views and any European directives
- Residential property most likely to be attractive to SIPPs rather than occupational schemes

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Maximising the advantages

▪Flexible retirement – allow people to phase into retirement
▪More options for members when they retire
-eg no minimum level of income under the two types of income withdrawal
-Compulsory open market option from DC scheme
-ASI
▪25% can be taken in the form of cash
-this compares with around 11-15% for many schemes under the current regime

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Maximising the advantages

▪Unrestricted pension benefits on death in service
▪Lump sum death benefits tax free if less than the lifetime allowance
▪Member contributions get tax relief
▪Annual limit well above the current levels for most people and no limits in the final year (assuming don't exceed the lifetime allowance)
▪Improved amounts for trivial commutation

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Implementing the changes

▪May be difficult to implement
-"the changes are branded as tax simplification but will be anything but simple to introduce" (Hammonds)

▪Timescales

▪Impact on scheme design

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Implementing the changes – scheme design

▪Depends on the starting point
▪For DC schemes business as usual but more flexibility re contributions and vesting of pension
▪Impact on cash balance schemes
-fit in with the lifetime allowance concept but
-Finance Bill problems
▪Is career average now more attractive than final salary?
▪Role of hybrids
▪Chance to change the past as well as the future?

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Implementing the changes – scheme design

▪Still need to provide "relevant benefits"
▪Pensions must be payable for life
▪Temporary pensions – not clear how these will be valued or even if they will be permitted
▪Review contracting-out
▪Promised flexibility to vary pattern of pension payments does not appear to have been included

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Implementing the changes
▪Decide whether to permit:
-allowing member to continue to work and draw pension
-partial vesting
▪Decide on phasing of increase in minimum retirement age
▪Decide how far to assist members to maximise their contributions both pre retirement and in the final year
▪If cash only scheme, fundamental redesign will be necessary
-in future cash can only be provided when pension is drawn
▪Consider death benefits to be provided
▪Decide whether to amend cash commutation percentage and factor

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Implementing the changes – effect on cash commutation

- % of pre-commutation pension which may be taken as cash = 1/(.15 x CF +1)
- So the lower the cash commutation factor the higher the proportion of pension which may be commuted, eg could take 40% with a 10:1 factor
- Will 20:1 factor used by the Inland Revenue lead to pressure for higher cash commutation factors?
- Don't forget the 20:1factor has spouse's pension in it

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Transitional protections

- Primary protection
  - Enhance LA by % exceeded at A day
  - 20:1 factor for accrued DB benefits, 25:1 for pensions in payment, 1:1 for accrued cash
  - Lump sum at A day indexed to LA
- Enhanced protection
  - Exempt from LA (s.t. pre A day IR limits)
  - No further accrual + restriction on earnings for DB
  - Lump sum as % (average) of total rights
- Other protections – single scheme lump sums over 25%, contractual right to pre 55 retirement

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Transitional protections

- Not clear if Revenue switch from valuing the accrued pension to valuing the early retirement pension was intentional
- If this provision remains need to consider what to do about schemes that don't allow early retirement
- Varying the early retirement factors
- For those with enhanced protection, the cash protection is averaged across schemes so members may seek practice changes to maximise scope pre A-Day?

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Transitional protections – some issues

- Valuation of temporary pensions?
- Valuing with profit policies
- Ascertain whether protection retained on onward transfer

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Transitional protections

- Revenue protections – who are they designed to help?
- Inland Revenue may, by regulations, make any modifications to rules of pension schemes
  - 'for relieving pension schemes of obligations to make payments which… …would be unauthorised payments'
  - 'modifications of provisions (however expressed) referring to any limit contained in… … any provision of Part 14 of ICTA'
  - only up to April 2009 or earlier if change the rules

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Death benefits

- Children's pensions must cease at age 23
- Cash out spouse's death in service pension?
- Or should a higher level of spouse's pension be paid?
- Lump sum benefits on death after retirement
- Opportunity for massively greater lump sum benefit, eg temporary or whole life assurance policies to cover mortgage
- Funeral benefits

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Dealing with high earners

- Decide on protection route before 6th April 2006
- Reviewing existing promises
- Shadow limits – desirable? Urgent?
- DB more favourable on current conversion terms
- Rolling in any unapproved provisions
- Permit taxed accrual? Provide lump sum or pension benefit? How to clawback the tax from the member?

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Consolidation or proliferation

- Will concurrency mean that people set up lots of policies?
- How much will people be able to rationalise existing policies?

- depends on view taken by insurance companies regarding changing past service benefits, eg to give 25% cash on AVC policies

- Might also depend on whether protections are transferable
- Arbitraging opportunities at the point of retirement switching between DC and DB
- Will schemes continue to have AVC facilities?

Tax simplification: new ideas in pension scheme design

- A pension is a pension is a pension
- But actually more cash, death benefits and a supplement to wages
- There are many advantages in the new regime for most people
- The challenge is in the implementation