What will the 5,000 (sic!) do after 6th April 2005 (Sic!)?

Pension Taxation Simplification

The Issues & Implications for Senior Executives

Marcus Whitehead

7 June 2004

Simplifying the taxation of pensions: the government's proposals

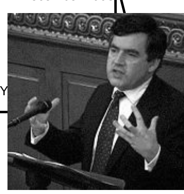
December 2003

H M TREASURY

Simplifying the taxation of pensions: increasing choice and flexibility for all

December 2002

TREASURY



17 March 2004

"I will replace the eight existing tax schemes for pensions with a single lifetime allowance"

Simplifying the taxation of pensions

- **Radical changes!**
- **A complete new regime for all schemes..**
- **… DB & DC, occupational & personal**
- **Introduced from April 2006 ('A Day')**

Simplifying the Revenue rules

- At present there are 3 occupational regimes:
  - Pre 1987 member
    - Uncapped pension
    - Uncapped lump sum
  - '87 – '89 member
    - Uncapped pension
    - Capped lump sum
  - Post '89 member
    - Capped pension
    - Capped lump sum
- And 2 individual regimes:
  - RAP: uncapped contributions
  - PPP: capped contributions

IR changes were never retrospective but this caused the complications

Pension Tax Reform 2006

Barnett Waddingham

Simplifying the taxation of pensions

- No pension limits
- No contribution limits
- No maximum funding checks
- No transfer restrictions
- No retained benefit cut back
- Single tax free lump sum rule
- Few investment restrictions
- Lifetime approach

Pension Tax Reform 2006

Barnett Waddingham

Simplification: at a glance

- £1.5 million Lifetime Allowance on benefits...
- … increasing to £1.8m by 2010
- "Recovery tax" of 25% on excess benefits
- Scheme pension to be valued against Lifetime Allowance using universal 20:1 factor
- Protection for existing benefits
- Tax free lump sum of 25% of benefits
- Excess benefits available as taxed lump sum
- £215,000 Annual Allowance for benefit accrual
- Minimum retirement age of 55 by 2010

Pension Tax Reform 2006

Barnett Waddingham

Simplification: today's agenda

- The Lifetime Allowance
- Recovery tax charge
- Protecting benefits at A Day
- Tax free lump sum
- Annual Allowance
- Death benefits
- Investment
- Retirement
- Divorce
- Unapproved schemes
- Reacting to Simplification

EVERYTHING!

Pension Tax Reform 2006

Barnett Waddingham

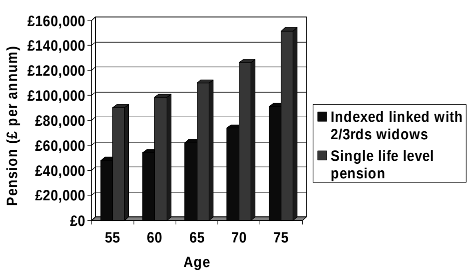
Simplification: the Lifetime Allowance

- ☹£1.5 million Lifetime Allowance on benefits...
- ☺… increasing to £1.8m by 2010
- ☹Not sure how Allowance will be indexed after 2010? Price inflation?
- ☹The limit includes <u>all</u> 'registered' pensions
- ☹It was described in 2002 as the cost at age 60 of the maximum capped pension…
- ☹…but that is already £1.85 million and rising!

Pension Tax Reform 2006

Barnett Waddingham

Male pension bought for £1,500,000



Source: FSA Comparative Tables May 04

Pension Tax Reform 2006

Barnett Waddingham

Simplification: the Lifetime Allowance

- Simple factor to value Scheme Pension against Lifetime Allowance
- 20 to 1 valuation factor to apply:
  - at all ages for men & women
  - for pensions increasing at greater of RPI or 5%pa
  - for spouse's pensions up to 100% of member's
  - applied after any pension commutation for lump sum, with lump sum taken at face value
- Permits £75,000pa pension at any age
- *Currently 33% more valuable than face value of Lifetime Allowance at age 60 & 50% greater at age 55!*

Simplification: the Lifetime Allowance

Crystallisation of benefits:

- Unsecured income: MV of Assets
- Scheme pension: 20 x Pension
  - insured annuity, selected by scheme administrator
  - non-reducing pension from scheme & > 50 mbrs
- Lifetime annuity: MV of Assets
  - insured annuity, selected by member
- Lump sum: Value of lump sum

Simplification: the Lifetime Allowance

- Each time benefits are taken the % of the Allowance used up will be certified by the scheme
- Member is responsible for disclosing whether they have sufficient unused Allowance
- Pensions in payment at A Day will be valued using a factor of 25 to 1
  - Higher factor to make an approximate allowance for lump sum taken prior to A Day
- Dependant's pensions will not count towards the Lifetime Allowance

Simplification: the Recovery Tax

- If the Lifetime Allowance is exceeded, then Recovery Tax is charged on the excess benefits at 25%
- × Income tax is paid in addition!
- × Effective total tax rate is 55%
- ✓ All excess benefits can be taken as a taxed lump sum
- ✓ Lower total tax impact than personal payment for medium term investment period

Simplification: protecting A Day benefits

- ➢ *Schemes will have 3 years – i.e. to 6th April 2009 to calculate for members:*
  - *Value of pension rights at A Day*
  - *Tax free lump sum entitlement at A Day*
  - *DB pension certified using a 20 to 1 factor*

Simplification: protecting A Day benefits

Choice of two ways to protect existing benefits:

EITHER "REVALUE"

- Certify benefits at A Day – within IR limits
- Revalue in line with Lifetime Allowance to date benefits drawn
- Only excess benefits over revalued figure incur "recovery tax"
- Post A Day benefits allowed (but taxed!)

OR "RING FENCE"

- Promise not to add to pension benefits after A Day..
- ..and all benefits (up to IR limits) will be protected, not just the revalued amount
- DB: (capped) salary linking
- DC: investment growth

Simplification: protecting A Day benefits

- DB Benefits:
  - Early retirement pension
  - IR Limit as at A Day
- Occupational DC Benefits:
  - MV of Assets
  - 20 x 2/3 x Annual Rate of Earnings
- PPPs/RAPs:
  - MV of Assets
  - No benefit limit

Pension Tax Reform 2006

Barnett Waddingham

Simplification: who should ring fence?

- Called ‘Enhanced Protection’
- Those with benefits valued above £1.5m
- Those with benefits approaching £1.5m…
- … who anticipate strong future earnings or investment growth
- Decision also influenced by employer pension options Post A Day
  - Care over wording of Rules: continued earnings link on opt-out?
- Can give up ring fencing later if proves not to be needed:
  - revert to “Revaluation” method, “Primary Protection”

Pension Tax Reform 2006

Barnett Waddingham

Simplification: ‘new’ Primary Protection

- Primary protection for DB benefits has been significantly watered down by Finance Bill
- Expected certification of accrued pension
- We have certification of early retirement pension
  - For those < 50, ERF applied as if member were 50
- Example:
  - Fred, age 50, £90,000 pa accrued pension, 60% ERF at 50
  - Expected: 90,000 x 20 = £1.8 million primary protection
  - We have: 90,000 x 0.6 x 20 = £1.08 million < £1.5 million
  - No Primary Protection!

Only a short time for lobbying on this issue!

Pension Tax Reform 2006

Barnett Waddingham

Protecting A Day benefits

DC EXAMPLE

	Revaluing	Ring Fencing
Fund at A Day	£1,600,000	£1,600,000
Fund at retirement after 20% growth	£1,920,000	£1,920,000
Re-valued Certified Amount	£1,760,000	Not applicable
Excess	£160,000	ZERO
Recovery tax at 25%	£40,000	ZERO

Ring-fencing can be valuable

Simplification: tax free cash

- ✓ ***New tax free limit is the <u>greater of:</u>***
  - *25% of lesser of benefit value/Lifetime Allowance*
  - *Pre A Day cash, indexed with the Lifetime Allowance or growth in benefit value (depending on protection option)*
- ✓ ***Many will get higher tax-free lump sums***
- ✓ ***Great plus for "87-89" & "post '89" members***
  - *The current limit is up to about £150,000*

Simplification: tax free cash

DB FORMULA

TAX FREE CASH =

$$\frac{\text{Pre-Commutation Pension}}{(3/20 + 1/\text{Commutation Factor})}$$

SIMPLICITY in action!

Simplification: Annual Allowance

- Annual Allowance to be £215,000
  - Increased to £255,000 by 2010
  - tax relief on e'ee contributions up to 100% of earnings
  - income tax liability on excess over Annual Allowance
  - DB pension growth valued using universal 10:1 factor
  - DB benefits from previous employments revalued at up to RPI will be ignored
- Dramatically simplifies & increases DC contribution scope in vast majority of cases
- Annual Allowance will not be applied in any year in which scheme benefits taken in full
  - e.g. enhanced redundancy or ill health benefits

Very welcome concession!

Simplification: Annual Allowance

EXAMPLE

- Suppose George is on 1/30th DB pension accrual, has 15 years' pension service and has a pay rise from £50,000 to £90,000…
- … that year the value of the increase is:
  15/30 x £40,000 + 1/30 x £90,000
  = £23,000 x 10 = £230,000
- Income tax on £15,000
- This will be a rare but possible situation

10 to 1 factor better than initially feared!

Simplification: contributions

- Anyone can receive tax relief on a contribution up to £3,600
- Occupational regime contributions:
  - salary and service become irrelevant
  - 15% employee contribution limit goes
- Full concurrency:
  - can be a member of occupational & personal pension from same earnings

Maximising pre A Day contributions?

- Worth considering – if:
  - Fund/benefit value is approaching or above £1.5 million already
  - Appropriate to use Enhanced Protection
  - Pre A Day contribution scope!

Will depend very much on individual circumstances and options

Pension Tax Reform 2006

Barnett Waddingham

Simplification: death pre retirement

- Survivor's pension for any dependant
  - without limit
  - but subject to income tax
- And/or lump sum
  - tax free up to greater of:
    - the Lifetime Allowance, or
    - certified value of retirement benefits
  - taxed at 55% above tax free level
- *Brings occupational death benefits in to line with PPP benefits*

May well see far more lump sum benefits

Pension Tax Reform 2006

Barnett Waddingham

Simplification: death post retirement

- Survivor's pension for any dependant
- "5 year guarantee" cash death benefit replaced by residual capital value payment taxed at 35%
- Income continuation guarantee, up to 10 years, to remain
- Where benefits are paid under income drawdown, death lump sum of residual fund (taxed at 35%) will still be available

☹ NO LUMP SUM DEATH BENEFITS ALLOWED AFTER AGE 75

Pension Tax Reform 2006

Barnett Waddingham

Simplification: investment issues

The Revenue to remove almost all restrictions!

- Property to be allowed
  - even residential!
- Personal chattels to be allowed
  - tax charge on personal use
- No restriction on share ownership
  - 5% limit on self investment
- Loans OK
  - but with some restrictions

Pension Tax Reform 2006

Barnett Waddingham

Simplification: retirement

Retirement Age

- "Normal Retirement Age" abolished
- Minimum retirement age ~~50~~ 55 from 2010
- Phasing in of change up to each scheme
- Transfers allowed at any time
- Pension may start even before current employment ceases completely:
  - as it always has for Personal Pensions

Pension Tax Reform 2006

Barnett Waddingham

Simplification: income drawdown

- New maximum income of 120% of market rate
- New minimum income drawdown of £1 pa a great boon...
- ... lump sum could be taken asap to reduce impact of recovery tax e.g. at age 55:
  - because lifetime allowance test only made at time of retirement

Pension Tax Reform 2006

Barnett Waddingham

Simplification: timing of retirement

- **People who should wait <u>until after A Day</u>**
  - Those whose lump sum is less than £375,000 & 25% of benefit value
  - Those wanting the new chance to pay high contributions
- **People who should retire <u>before A Day</u>**
  - Those wanting to escape the changeover hassle?

Pension Tax Reform 2006

Barnett Waddingham

www.barnett-waddingham.co.uk

Simplification: divorce

- **Pensions sharing to continue..**
- **..but the party "losing" the share is no longer proposed to have a permanent reduction in their lifetime allowance….**
- **…whilst the party "receiving" the transfer must offset the credit against their allowance**
- ***This is reasonable – and more equitable than the initial proposals***

Pension Tax Reform 2006

Barnett Waddingham

www.barnett-waddingham.co.uk

Simplification: unapproved schemes

- **In 1989 the government introduced the earnings cap at £60,000 pa…**
- **… but said "there will now be complete freedom to provide benefits above the Inland Revenue limits"…**
- **... "though without the tax relief"**
- ***FURBS & UURBS were born!***

Enabled E'ers to provide pension benefits for capped executives

Pension Tax Reform 2006

Barnett Waddingham

www.barnett-waddingham.co.uk

Simplification: FURBS

- Tax favoured status will cease from A Day
- Investment returns to be taxed at rate applicable to trusts ~ typically 40%
- Pre A Day contributions
  - tax free lump sum remains on retirement post A Day
  - inheritance tax protection remains post A Day
- Post A Day contributions
  - no tax or NI charge on payments & no e'er relief
  - retirement lump sum taxed on e'ee & e'er gets relief (?)
  - no inheritance tax protection
- Outside Lifetime Allowance

Not good news for FURBS

Pension Tax Reform 2006

Barnett Waddingham

Simplification: FURBS

- FURBS contributions after A Day look far less attractive
- Existing FURBS may wish to reduce income tax exposure in favour of capital gains
- Existing FURBS members may investigate taking benefits early

? ***How to meet existing pension promises worth > £1.5 million for senior executives?***

Pension Tax Reform 2006

Barnett Waddingham

Simplification: UURBS

- Continue in their current form
- Not counted against Lifetime Allowance
- Not counted against Annual Allowance
- Securing an unfunded promise with a company asset will still be permitted
- E'ers may insure unfunded benefit against risk of default on e'er insolvency:
  - Premium to be taxable benefit in kind on e'ee

Future looks good for UURBS

Pension Tax Reform 2006

Barnett Waddingham

Reacting to Simplification

Alternative excess compensation:

- Salary supplement *Straightforward*
- Maintain scheme benefits *The new FURBS?*
- FURBS *Tax inefficient?*
- UURBS *Saves NI, security issues?*
- Advance funding *Too generous? Affects cash flow?*

Improving benefits for capped employees

- Member of final salary scheme
- Subject to the earnings cap (joined scheme after 1 June 1989)
- Earnings greater than the cap (£102,000 for 2004/05)
- Less than 20 years total service to retirement
- Capped retirement benefits expected to be below Lifetime Allowance

Will the company want to re-visit and give a better benefit?

Improving benefits for capped employees

EXAMPLE

- On joining executive might have expected £120,000 x 10 years/30 = £40,000 pa
- But under current regime actually gets £102,000 x 10 years/30 = £34,000 pa
- Proposed regime would give a 'value' of £40,000 x 20 = £800,000
- Well within the new £1.5m Allowance (depending on other benefits)

Does the company offer to improve?

Simplification: uncapping of benefits

- So employer could be more generous
- ? ..but will they want to?
- ? Will the e'er have to? There would be an increase in approved pension liability for past & future service
  - Definition of pensionable earnings in Rules?
  - Pension commitment in employment contract?
  - Create a 'scheme earnings cap' from A Day?
- ? Danger of double provision of pension benefits if top-up arrangements made for earnings above the cap?

Pension Tax Reform 2006

Barnett Waddingham

Simplification: Six of the Best

1. Greater benefit and contribution scope for many
2. Better tax free cash for many
3. Ring-fencing of pre A Day benefits
4. 20 to 1 Scheme Pension valuation factor
5. No more "early retirement" problem
6. Better lump sum death benefits for many

Pension Tax Reform 2006

Barnett Waddingham

Simplification: what happens next?

1. Finance Bill to receive Royal Assent July 2004?
2. Regulations expected Autumn 2004
3. Act comes into effect 6 April 2006
4. Start planning now!

Pension Tax Reform 2006

Barnett Waddingham


www.barnett-waddingham.co.uk
Q&A
Pension Tax Reform 2006
Barnett
Waddingham