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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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

Maximum relieviable member cons greater of £3,600 or 100% of earnings (can pay more, but no relief)
Employer cons 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

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

£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

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

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

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?

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

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

\[
1/(0.15 \times CF + 1)
\]

- So the lower the cash commutation factor the higher the proportion of pension which may be commuted, e.g., 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 20:1 factor has spouse’s pension in it.

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

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

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

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?

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?

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