

**PENSIONS: THE NEW TAX RULES
WHERE ARE WE NOW?**

Following widespread consultation with the pensions industry in 2003 and 2004 regarding the simplification of the tax regime for all tax approved pension schemes, legislation was enacted in the Finance Act 2004 to introduce a new tax regime for all pension schemes with effect from 6 April 2006. This Memorandum provides an explanation of the main provisions contained in the Finance Act 2004, as amended by the Finance Act 2005, and draws the attention of clients to the need to consider their options in advance of 6 April 2006.

THE MAIN PROVISIONS

All the current tax regimes for pension schemes will be replaced from 6 April 2006 by one tax regime covering tax reliefs, investments and benefits, and allowing full concurrency for different employments. There is to be one single consistent set of rules for all pension schemes. The new regime will encompass both money purchase and final salary pension schemes.

Tax relief in relation to the funds of any pension scheme from 6 April 2006, so far as any member is concerned, is to be restricted to a lifetime ceiling of £1.5m rising to £1.6m in 2007/08, £1.65m in 2008/09, £1.75m in 2009/10 and £1.8m in 2010/11. Thereafter the lifetime ceiling will be reviewed every 5 years. These limits will be tested when members draw benefits. Any excess value above the lifetime limit will be taxed at 25% and any pension will be liable to tax under PAYE. If the excess is taken as a lump sum the tax charge will be 55%.

The maximum earnings cap for tax relief purposes is to be abolished (£105,600 for 2005/06) and replaced by an annual limit on contributions subject to an earnings qualification. The annual limit is £215,000 for 2006/07 set on the member's/employer's contribution, being no more than 100% of earnings and on which tax relief will be given. The earnings of directors and members of their families from private investment companies will become fully pensionable under the new regime. It will be possible to make a contribution of more than 100% of earnings, but tax relief will be restricted to the annual limit and the excess over the annual limit will be subject to a tax charge of 40% payable by the member. The annual limit will increase to £225,000 in 2007/08, £235,000 in 2008/09, £245,000 in 2009/10 and £255,000 in 2010/11. Thereafter the annual limit will be reviewed every 5 years. Tax relief on contributions carried back for personal pension schemes and retirement annuity contracts will be abolished as will the facility to carry forward reliefs for contributions for retirement annuity contracts.

The payment of retirement benefits from all pension schemes will only be allowed from age 55 (currently 50) starting in 2010. The income draw-

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down facility will be available from all pension schemes from age 55 together with phasing. The lower normal retirement ages for entertainers, sportspeople and hazardous occupations are to be abolished from 6 April 2006, but members with normal retirement ages below 50 before that date will be able to retain them subject to a reduced lifetime allowance. All members will be able to contribute in respect of two or more concurrent employments. They will also be able to take retirement benefits from age 55 including income draw-down and remain in the same employment.

Cash lump sums on retirement will remain tax-free and personal contributions will attract higher rate tax relief where relevant under the new regime. Cash lump sums paid on retirement will be up to 25% of the value of the fund (£375,000 on the lifetime limit of £1.5m in 2006/07). Death benefits are to be the same for all pension schemes. The whole of the fund may be paid on death if benefits have not been taken or the whole fund used to pay a smaller cash lump sum and survivors' pensions. If death occurs during income draw-down, any cash lump sum paid from the fund in draw-down would be liable to a 35% tax charge. Survivors' pensions could also be paid or annuities purchased.

Where pension schemes can provide the appropriate security of income, pensions can continue to be paid from the scheme for life, e.g. large self-administered and wholly insured pension schemes. The age 75 restriction on purchasing an annuity will remain though where relevant, e.g. SSAS and SIPPS. It will also be possible to pay an unsecured pension up to age 75 by which age it must be secured. An alternative to providing a secured pension will be an *alternatively secured pension*. This can be paid from the member's fund with no need to purchase an annuity by age 75. However, no lump sum death benefits can be paid, only dependent's pensions.

One common investment regime will exist for all schemes after 5 April 2006, i.e. apart from insured schemes. All self-administered schemes, SSAS, SIPPS and large self-administered schemes will be able to invest in the same areas with some exceptions. For SSAS and large self-administered schemes for instance, loans to and unquoted shares in the sponsoring company will be restricted to 50% and 5% respectively of the value of the fund. Loans may be further restricted to 5% of the value of the fund where all the members are not trustees. Investment in residential property will be permitted, but if a member occupies the property at less than a commercial rent, a tax charge will be payable by the member at 40% of the value of the benefit in kind obtained regardless of their effective rate of tax. It will also be possible to sell one's own home to the fund at market value, or to buy a property from the fund to be used as one's own home.

Transitional arrangements have been put into place so that members of schemes who already have pension savings in excess of the new allowances are not penalised. These will protect members from the tax recovery charge in respect of funds accrued prior to the commencement

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date of the new regime. *Primary protection* is available where the capital value of all of a member's benefits accrued prior to 6 April 2006 exceed the lifetime limit of £1.5m. Any increase in their value at the date of vesting up to the value of the statutory increase in the lifetime limit will be protected from the recovery charge. *Enhanced protection* is available to protect fully the capital value of all of a member's benefits accrued prior to 6 April 2006 regardless of their aggregate value at 6 April 2006 or at the date of vesting. However, this option is subject to the member ceasing all pension contributions and active membership of all pension schemes from 6 April 2006. Members have until 5 April 2009 to register for *primary or enhanced protection* against the tax recovery charge. This will also protect any existing tax-free cash lump sum entitlement of more than £375,000. *Primary protection* will enable the protected tax-free cash lump sum to increase in line with the statutory increase to the lifetime limit up to the vesting date. *Enhanced protection* will protect the full value of the tax-free cash lump sum, i.e. it can increase in proportion to the increase in the value of the member's fund.

It will be permitted to transfer pension rights between registered pension schemes from 6 April 2006 without restriction and without triggering a test against the lifetime limit. Transfers to recognised overseas schemes will be allowed, but will be treated as a vesting event for testing the lifetime limit. Transfers to non-registered UK pension schemes will not be allowed.

CLIENT ACTION

The new tax regime for pension schemes commences on 6 April 2006. Before then corporate clients with occupational pension schemes and individual clients who are members of tax approved pension schemes will need to consider along with their tax, actuarial and financial advisers, the effect of the new legislation on themselves and the options available, and what, if anything, they should do. It should be borne in mind that the new pensions regime will not benefit everyone. The following points, which are not exhaustive, are intended to alert clients to where they should act.

Companies should review pensions as part of their overall remuneration strategy. They should consider reducing the number of different pension arrangements and decide on any alternatives, e.g. cash. They should also understand the consequences of doing nothing.

Companies contributing to insured pension schemes and SSAS are currently restricted by HM Revenue & Customs rules as to the amounts they can pay. Members' pensionable service in these schemes ceases on 5 April 2006, but even though such contributions are partly based on members' service, HM Revenue & Customs has confirmed there can be no change in the level of contributions up to 5 April 2006. However, if such schemes are currently overfunded, but below the £1.5m lifetime allowance, it will permit these schemes to receive contributions up to

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£215,000 from 6 April 2006 provided no *primary or enhanced protection* is sought.

Funding personal pension schemes and retirement annuity contracts to the maximum permitted under current rules by 5 April 2006, if financial circumstances permit, should be considered by both members and employers as contributions thereto after that date will no longer be permitted if a member opts for *enhanced protection*. Members of occupational pension schemes should similarly consider contributing up to the maximum of 15% of pensionable earnings in 2005-06 to their occupational or free standing additional voluntary contribution scheme. Members of personal pension schemes should consider paying maximum contributions in 2005/06, including contributions to be carried back to 2004/05, as 31 January 2006 will be the last date for carry back elections. Members of retirement annuity contracts should consider paying maximum contributions in 2005/06 for both these reasons and to ensure unused reliefs available for carry forward are fully used by 5 April 2006. Such members have until 31 January 2007 to elect for a contribution paid in the year ended 5 April 2006 to be carried back. If the value of a member's fund is already in excess of £1.5m, payment of such contributions may be advisable to maximise benefits under the current regime as such members will not be able to contribute to a new pension scheme after 5 April 2006. However, where the value of a member's fund is below £1.5m (which limit may or may not be breached by contributions by 5 April 2006) the options for *primary or enhanced protection* will need to be considered very carefully to ensure members are in the optimum position when the new regime commences.

Members should check the value of their pension scheme benefits before 6 April 2006, including any pensions already in payment. If they have benefits under a final salary scheme they should obtain the value of their accrued pension savings at 6 April 2006 and add this to the value of any money purchase pension scheme and pension in payment for comparison with the £1.5m lifetime limit. They should then consider if it would be appropriate to register for *primary or enhanced protection*.

It will be advisable to register any pension credit arising from a pensions sharing order on divorce made prior to 6 April 2006 for protection from the tax recovery charge. An individual in the process of divorce with a possible entitlement to a pension credit should try and finalise the divorce before 6 April 2006 and register their pension credit for protection.

If an individual wishes to transfer their occupational pension scheme benefits or Section 32 policy into a personal pension scheme, but has been unable to do so because the transfer fails the current prescribed test, it may be preferable to wait until 6 April 2006 and try again. Members of retirement annuity contracts also considering transferring their retirement benefits to a personal pension scheme by 5 April 2006, perhaps to enjoy the income draw-down facility, will need to consider such a move as it may preclude them from continuing their retirement annuity contract under

the new regime where it will feature the draw-down facility for the first time.

Members of all pension schemes with low normal retirement ages who would from 2010 onwards have been able to draw their retirement benefits from say age 40, but will be unable to do so instead until age 55, or may be able to do so only with a 2.5% pa reduction to the lifetime limit, should consider whether the *primary or enhanced protection* options would be more beneficial.

Members of all pension schemes will need to consider the amounts of cash lump sum benefits payable on retirement and death under both the current and new regimes. The retirement lump sum could be greater under the current regime than under the new one, whereas the lump sum death benefit could be greater under the new regime than under the current one. The opportunity to maximise one or the other benefit should be considered by 5 April 2006 and whether *primary or enhanced protection* would be the best option. If a member needs to register for protection of a tax-free cash lump sum, any proposed transfer of pension benefits should be completed before 6 April 2006 as a transfer made after that date will lose that protection.

There will be instances where a member with a pension already in payment at 6 April 2006 will have taken, or had the opportunity to take, a tax-free cash lump sum, or where a member may have taken a tax-free cash lump sum before 6 April 2006 and deferred the associated pension until later whilst continuing to work for the employer or be contemplating such a course of action. Under the new regime however such a member will be unable to obtain a further tax-free cash lump sum after 5 April 2006 in relation to that employer. Members in any of these circumstances who have not yet taken a tax-free cash lump sum should consider doing so by 5 April 2006 if it will be greater than the lump sum they could receive under the new regime.

Marked fluctuations in fund values, particularly in excess of the lifetime limits for the current tax regime of £1.5m, or more if fund values on 5 April 2006 are greater, and the new regime of £1.5m, will require constant monitoring and advice both pre and post 6 April 2006. For instance, UK equity values may return to their former levels at a rate greater than the statutory increase in the lifetime limit creating a potential tax charge at 25% on the excess funding. It would be most advisable therefore to revalue pension scheme assets, particularly land and property, before 6 April 2006. If a self-administered occupational or personal pension scheme currently owns property with planning or development permission it may be advisable to sell the property by 5 April 2006, thus realising the development value and establishing the members' lifetime limit in the current pension scheme even if it becomes greater than £1.5m. If such an increase in value to the member's fund takes place after 5 April 2006, it could generate a tax charge on the value of the fund in excess of £1.5m or its future increased equivalent.

FOR GENERAL INFORMATION ONLY

The information given in this Memorandum is based upon our current understanding of HM Revenue & Customs' legislation. We would emphasise that various statutory instruments will be issued before 6 April 2006 with more details of how the new regime will operate and there may therefore be further changes to the new regime before implementation. Please note that this Memorandum is not intended to give specific technical advice and it should not be construed as doing so. It is designed merely to alert clients to some of the issues. It is not intended to give exhaustive coverage of the topic.

Professional advice should always be sought before action is either taken or refrained from as a result of information contained herein.