

## **REFORM OF PENSIONS**

In December 2002 the Inland Revenue published a consultation document, "Simplifying Taxation of Pensions: Increasing Choice and Flexibility for All". The aim of the document, if its proposals are adopted, is to sweep away the great mass of complicated Inland Revenue legislation and guidance covering all tax approved pension schemes, to make pensions easier to understand for members and to administer for providers, and to increase the choice and flexibility available to members. This Memorandum provides an explanation of the main proposals and draws the attention of clients to areas where they may need to act both before and after the proposals are implemented. In June 2003, the Government announced that implementation of the new proposals had been deferred to 6 April 2005.

### **THE PROPOSALS**

All the current tax regimes for pension schemes will be replaced from 6 April 2005 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 be based on money purchase, although final salary pension schemes may continue.

Tax relief in relation to the funds of any pension scheme established from 6 April 2005 is to be restricted to a lifetime ceiling of £1.4m indexed annually thereafter so far as any member is concerned. This limit will be tested when members draw benefits. Any excess value above the lifetime limit will be treated as a funded unapproved retirement benefits scheme and taxed at 33 $\frac{1}{3}$ % and in addition income tax on the member at their effective rate will be collected by self-assessment.

The earnings cap is to be abolished (£99,000 for 2003/04) and replaced by an annual limit subject to an earnings qualification. The annual limit is to be £200,000 set on the member's/employer's contribution, being no more than 100% of earnings and on which tax relief will be given. The annual limit will be indexed. 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 age 50) starting in 2010. The income draw-down facility will be available from all pension schemes from age 55 together with phasing. The lower normal retirement ages for entertainers, sports persons and hazardous occupations are to be abolished. 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.

It has been confirmed that cash lump sums on retirement will remain tax-free and that personal contributions will attract higher rate tax relief where relevant under the

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### *Factsheet*

new regime. Cash lump sums paid on retirement will be up to 25% of the value of the fund (£350,000 on the proposed lifetime limit of £1.4m). 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. The age 75 restriction on purchasing an annuity will remain though where relevant, e.g. SSAS. However, the Inland Revenue has indicated that it is prepared to abandon its requirement to purchase an annuity where income draw-down is being operated, though it will not then permit the payment of any lump sum on death after age 75.

It is envisaged that one common investment regime will exist for all schemes after 5 April 2005, i.e. apart from insured schemes. All self-administered pension schemes, SSAS, SIPPS and large self-administered schemes, would be able to invest in the same areas with some exceptions. For instance, loans to and unquoted shares in the sponsoring company would be restricted to 5% of the value of the fund. Investment in residential property would be permitted with any member use being taxed under self-assessment.

It appears that a dividing line is to be drawn between the retirement benefits accrued under all current pension schemes up to 5 April 2005 and the retirement benefits accrued thereafter. We understand that no transfers of retirement benefits between pension schemes in the current regime and the new regime will be permitted. Transfers will apparently only be permitted from 6 April 2005 between pension schemes in the pre 6 April 2005 regime or in the post 5 April 2005 regime. Former pension rights will continue to be indexed and honoured, but if their value at 6 April 2005 exceeds the lifetime limit of £1.4m, that value becomes the lifetime limit. For instance, if the value of member's retirement benefits from their only pension scheme or in aggregate from all their pension schemes at 5 April 2005 is £2.5m, then £2.5m indexed in future years will be the lifetime limit for their pre 6 April 2005 retirement benefit. In these circumstances no retirement benefits can be built up under the new regime. All funds built up in the a 6 April 2005 fund in excess of the indexed limit will be subject to a recovery charge of 33 $\frac{1}{3}$ % at the time benefits are taken.

### **CLIENT ACTION**

Until the proposed tax regime for pension schemes commences on 6 April 2005 clients who are members of all tax approved pension schemes will need to consider prior to that date and afterwards, along with their advisors, the effect of the proposals, if implemented, on themselves and what, if anything, they should do. The following points, which are not exhaustive, are intended to alert clients to where they should act.

Funding personal pension schemes and retirement annuity contracts to the maximum permitted under current rules by 5 April 2005, if financial circumstances permit, should be considered by both members and employers as contributions thereto after that date will no longer be permitted. Members of occupational pension schemes should consider contributing up to the maximum of 15% of pensionable earnings in 2003/04 to their occupational pension scheme or free standing additional voluntary contribution scheme. Members of personal pension schemes should consider paying maximum contributions in 2003/04 and 2004/05 including contributions to be carried back to 2002/03 although it is not yet clear if 31 January 2005 will be the last date for carry back elections. Members of retirement annuity contracts should consider paying maximum contributions in 2003/04 for both these reasons and to ensure unused reliefs available for carry forward are fully used by 5 April 2005. If the value of a member's fund is already in excess of the lifetime limit of £1.4m, payment of such contributions may be advisable to maximise benefits under the current regime as such members will not be able to establish a new pension scheme after 5 April 2005. However, care will need to be exercised where the value of the member's fund is below £1.4m which limit may or may not be breached by contributions by 5 April 2005, as the opportunity to establish a further pension scheme thereafter could be affected.

Employers contributing to insured pension schemes and SSAS are currently restricted by Inland Revenue rules as to the amounts they can pay. Members' pensionable service in these schemes will cease on 5 April 2005 and as contributions are partly based on members' service, advice should be sought on the employer's contribution to be paid by 5 April 2004.

Members of retirement annuity contracts considering transferring their retirement benefits to a personal pension scheme by 5 April 2005, perhaps to enjoy the income draw-down facility, will need to consider such a move as it may preclude them from establishing a retirement annuity contract from 6 April 2005 which will feature the draw-down facility for the first time. Individuals who are not members of retirement annuity contracts at 5 April 2005 will not be able to establish a retirement annuity contract under the new regime.

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 who will not be able to do so instead until age 55, should seek advice before 5 April 2005.

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 benefits should be considered, possibly in conjunction with a transfer of retirement benefits by 5 April 2005.

Marked fluctuations in fund values, particularly in excess of the lifetime limits for the current tax regime of £1.4m, or more if fund values on 5 April 2005 are greater, and the new tax regime of £1.4m (both indexed in future), will require constant monitoring and advice both pre and post 6 April 2005. For instance, UK equity values may return to their former levels at a rate greater than the indexation of the lifetime limit creating a potential tax charge of 33⅓% on the excess funding. 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 2005 thus realising the development value and establishing the member's lifetime limit in the current pension scheme even if it becomes greater than £1.4m. If such an increase in value to the member's fund takes place after 5 April 2005, it could generate a tax charge on the value of the fund in excess of £1.4m or its future indexed equivalent.

**FOR GENERAL INFORMATION ONLY**

The information given in this Memorandum is based upon our current understanding of the Inland Revenue's proposals. We would emphasise therefore that these are only proposals at present and that they may change before implementation. In addition, the Inland Revenue has undertaken to clarify its proposals on various matters, e.g. funded unapproved retirement benefit schemes where a further consultation document is expected, the eligibility of directors of investment companies joining the new regime, the last date for paying contributions to a personal pension scheme or retirement annuity contract to be carried back to the previous year, and on transfers after 5 April 2005. Revised proposals are scheduled to be published in October 2003 following the Government's consideration of the initial consultation stage.

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 to merely 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.