FRESHFIELDS BRUCKHAUS DERINGER

December 2003

BRIEFING

Provision of pension benefits over the lifetime allowance

Proposed new regime from April 2005
Employment, pensions and benefits: briefing 105

Executive summary

Perhaps unexpectedly, the Revenue proposals published on 10 December 2003 did not seek to eliminate all forms of unapproved pension provision. Both the earlier Inland Revenue paper and the Department for Work and Pensions paper issued in December 2002 suggested that the aim was to reduce the eight current tax regimes (including funded unapproved schemes and unfunded unapproved schemes) to one regime, so it seemed that steps might be taken to eliminate unapproved schemes. However, instead the intention is to remove all tax advantages from both funded and unfunded unapproved arrangements.

On 10 December 2003 the government published the Inland Revenue's second consultation paper on pensions, *Simplifying the taxation of pensions: the government's proposals*[1]. Details are set out in our briefing no. 104 *Government proposals for simplifying the taxation of pensions* (December 2003). This briefing looks at the key features of the proposed new regime for those who may accrue benefits which will exceed the new lifetime allowance and at the future of unapproved (or 'unregistered') arrangements.

'Registered' schemes (ie approved schemes)

- The ability to contribute up to 100 per cent of UK earnings has been retained – it will therefore be possible for employees to contribute large amounts in any particular year (subject to the new lifetime and annual allowances).
- The lifetime allowance will be £1.4m from 6 April 2005 (A-Day). It will be increased annually with prices (Retail Prices Index, RPI). Lobbying to have this increased (to £1.8m or £2.0m) was not successful.
- A fixed ratio of 20:1 will be used for all ages to value defined benefits for the purposes of testing against the lifetime allowance (subject to individual factors being required if the scheme benefits are not sufficiently similar to the assumptions). Depending on how this compares with the actuarial rate for conversion of the defined benefits provided, the true value of the maximum benefit may be able to be increased by switching between defined benefit and defined contribution arrangements.
- Where benefits in a registered scheme exceed the lifetime allowance, the excess will be subject to a recovery charge of 25 per cent (reduced from 33.33 per cent in the December 2002 proposals). This may be penal for funds invested for a short period, but it is intended to be cost-neutral. For some individual circumstances, it could be attractive. For those near the limit, the extra tax may not be significant compared with, for example, the costs of establishing alternatives.
- Funds above the lifetime allowance do not have to be taken in the form of pension. They can be taken as a lump sum but will be taxed at 55 per cent. (This is the rate obtained by applying the 25 per cent recovery charge and then 40 per cent (income tax) to the remaining 75 per cent.)
- The annual allowance has been retained – employees will be taxed at their marginal rate if the annual increase in the capital value of their benefits exceeds £200,000 in any year (from April 2005, increased annually by RPI). This will not apply in the year that benefits are taken in full (ie will not affect death benefits or early retirement) but will affect promotions.
- A fixed ratio of 10:1 is used for all ages to calculate the increase in capital value for the purposes of testing benefits against the lifetime allowance (subject to individual factors being required if the scheme benefits are not sufficiently similar to the assumptions).

[1] Available at www.hm-treasury.gov.uk/pre_budget_report/prebud_pbr03/assoc_docs/prebud_pbr03_adpension.cfm.

Protection of accrued benefits on 6 April 2005 ('transitional protection')

- The original proposals suggested a method whereby benefits in excess of the lifetime allowance could be registered as at A-Day (with three years actually to lodge the registration). The stated intention was to preserve the accrued benefits but as the registered amount could only increase by RPI the real effect was retrospective taxation, as benefits would be likely to increase in value by more than RPI even if no further contributions were paid or benefits accrued.
- The 10 December paper included an alternative whereby the accrued benefit is entirely preserved if the member opts out of active membership with effect from A-Day. In practice, we assume that most employees with benefits already in excess of the lifetime allowance would choose to do this, as any benefits accrued after A-Day would be above the lifetime allowance (unless there was a fall in the value of benefits eg if the member had defined contribution benefits and the fund value dropped). Even with the lower level of recovery charge, there will usually be a more efficient means of providing benefits for most employees.

Further details are set out in our briefing *Government proposals for simplifying the taxation of pensions* (December 2003).

Furbs, Uurbs and Suurbs

The government's view (expressed in the December 2003 paper) is that the new regime will be sufficiently flexible to allow for unlimited pensions within registered schemes, with the only limit being on how much tax relief is given. Benefits up to the lifetime allowance (£1.4m in April 2005, increased annually by RPI) and the annual allowance (£200,000 in April 2005, increased annually by RPI) will enjoy tax relief. Benefits can be provided above the lifetime allowance, subject to the recovery charge which the government now proposes to set at 25 per cent.

As the benefits that can be provided from registered schemes are unlimited, funded unapproved retirement benefit schemes (Furbs) and unfunded unapproved retirement benefit schemes (Uurbs) may not be necessary as separate top-up vehicles to provide benefits to high earning employees, in the government's view.

However, the proposed new regime for Furbs and the ability to continue to operate Uurbs as well as securitised unfunded unapproved retirement benefit schemes (Suurbs) will mean that these unapproved (or unregistered) arrangements will continue to have their uses. In many cases, it will be more tax-efficient to provide benefits above the lifetime allowance through an unregistered scheme than through the registered scheme, subject to the recovery charge (25 per cent).

Furbs

From A-Day, Furbs will be taxed in the same way as employee benefit trusts. This will mean that:

- employees will not be subject to income tax on employer contributions;
- national insurance contributions (NICs) will not be payable in respect of employer contributions;
- employers will *not* get a corporation tax deduction when contributions are paid;
- employees will pay income tax only when benefits are paid (whether as lump sum or pension);
- national insurance contributions should not be payable when pension benefits are paid;
- employers will get a corporation tax deduction only when benefits are paid; and
- investment income of the trust will be payable at the rate applicable to trusts (currently 34 per cent but to rise to 40 per cent under separate government proposals also announced on 10 December).

This represents a significant shift from the current position for Furbs. The table opposite highlights the changes.

The effect on Furbs is not as drastic as it might have been. There were rumours that double taxation might have been imposed so that employees would be taxed on employer contributions and benefits would be taxed when paid whatever their form.

The proposed structure of deferred taxation (with deferred corporation tax relief) may mean that Furbs (as opposed, say, to salary increases) remain attractive in appropriate circumstances, although there are obviously issues for employers in the payment of contributions which are not tax deductible at the time they are paid.

Furbs	Current position	Proposed position from April 2005
Employer contributions	Taxed as income in the hands of the employee. Deduction allowed for corporation tax on normal principles.	Not taxed as income in the hands of the employee. No deduction for corporation tax.
NICs	The Revenue claims that Class 1 NICs are payable, although the legal position is unclear.	No NICs in respect of employer contributions.
Investment income	Currently pay tax at the basic rate.	The rate applicable to trusts to rise to 40 per cent.
Payment of lump sum	Tax-free (if conditions satisfied).	Subject to income tax.
Payment of pension	Subject to income tax.	Subject to income tax.
Benefits	Need to provide 'relevant benefits' to obtain limited tax advantages eg the ability to pay a tax-free lump sum.	Benefits must be consistent with those which can be provided through registered schemes to avoid attracting NICs.
Inheritance tax (IHT)	No IHT is payable where benefits are paid under a trustee discretion.	Current advantages to be removed.

Transitional protection for Furbs

Where an employee has been taxed on employer contributions to a Furbs before A-Day, the ability to pay a tax-free lump sum in respect of those contributions will remain. There may, therefore, be persuasive arguments to accelerate contributions to Furbs in appropriate circumstances. Contributions can continue to be made to the Furbs (on the new basis ie no income tax/no corporation tax deduction for contributions). An adjustment will be made to the tax-free element of any lump sum benefit which is paid. This will take into account any employee contributions (although in practice these are rarely made) and the proportion of the fund which has been taxed under the current rules.

Amounts in Furbs at A-Day will continue to retain their pre-A-Day favourable inheritance tax treatment. Where additional contributions are made after A-Day, funds will be apportioned. It is not clear whether this will be on a share of fund basis or whether the funds in the Furbs at A-Day will be increased by RPI to mirror the approach for benefits accrued to A-Day in registered schemes.

Uurbs and Suurbs

Very few changes are proposed.

Employees will not be charged to income tax as benefits accrue. A charge to tax will arise when benefits are paid, whether in lump sum or pension form. This may make payment in lump sum form unattractive in some circumstances.

The Revenue has not sought to impose a charge to income tax on Suurbs as benefits accrue. However, where an employer insures the unfunded promise against the risk of default on account of the insolvency of the employer, income tax (and Class 1A NICs) will be payable on the premiums as a benefit in kind.

There was concern that the Revenue would shift to an approach which imposed income tax on Uurbs benefits as they accrue, even where there was no security. The proposals in the December 2003 paper are, therefore, good news for employers and employees who favour these sorts of arrangements. In view of the changes to Furbs, we may well see a renewed interest in Uurbs and Suurbs from April 2005.

Rollover relief for Uurbs

Any Uurbs in place on the day before A-Day may be consolidated and rolled into a registered scheme within a period of three months from A-Day. The employee would not suffer a tax charge on the basis that the increase in the value of benefits in the registered scheme exceeds the annual allowance but the benefits would count towards the lifetime allowance. The ability to fund existing Uurbs in this way may be attractive to employers who are looking at ways of 'cashing-out' existing Uurbs.

Other methods of provision above the lifetime allowance

Although a recovery charge will apply where the benefits in a registered scheme exceed the lifetime allowance, that may in some circumstances be more attractive than, for example, funding through a Furbs under which contributions would not be deductible for corporation tax purposes under the new regime or would give rise to an immediate income tax charge (and arguably NICs if the Revenue view is correct) under current rules. It could also be helpful in relation to employees who may have total benefits below the lifetime allowance but who required a top-up arrangement because of the speed at which benefits were to accrue.

Where an employee has more than, say, ten years before his intended retirement day, it may be tax-efficient for all retirement benefits to be provided through a registered scheme. As noted above, the government now proposes to reduce the recovery charge from the 33.33 per cent proposed in December 2002 to 25 per cent. The new rate is intended to be tax-neutral and could, in fact, be attractive in circumstances where the funds have enjoyed a relatively long period of tax-favoured investment. This could be an appropriate approach, for example where an employee may not exceed the lifetime limit to any material extent.

The proposals merely provide that schemes are required to withhold benefits to cover the recovery charge, and the amount of withholding tax accounted for by the scheme may be set against the individual's liability (the recovery charge is primarily assessable on the member, although schemes will be required as a matter of procedure to pay it through PAYE withholding tax). Schemes will be free to decide how to meet the liability on them to withhold tax, for example by reducing the member's benefits or paying on a grossed-up basis. There may be scope for minimising the effect on the member of the application of the recovery charge.

Action now

Potentially each affected employee will have a different solution which is most efficient for him. Assuming the National Audit Office confirms the government's figures (see our briefing no. 104), the new regime will come into force on 6 April 2005. Employers should start collecting all relevant information to assess:

- employees who are currently capped/ uncapped;
- employees who will have accrued the lifetime allowance by 6 April 2005 (and those close to it);
- what top-up arrangements may already be in place – companies need to start considering what policy to adopt in the context of remuneration packages and the extent to which individual solutions will be offered to meet an employee's individual circumstances; and
- whether employment contracts will need to be revised to take account of the proposed new arrangements.

For further information please contact

Ken Dierden
T +44 20 7832 7055
F +44 20 7832 7001
E ken.dierden@freshfields.com

David Pollard
T +44 20 7832 7060
F +44 20 7832 7001
E david.pollard@freshfields.com

Catherine McAllister
T +44 20 7832 7742
F +44 20 7832 7001
E catherine.mcallister@freshfields.com

The information and opinions contained in this bulletin are not intended to be a comprehensive study, nor to provide legal advice, and should not be relied on or treated as a substitute for specific advice concerning individual situations.

© Freshfields Bruckhaus Deringer 2003

www.freshfields.com

7335