FRESHFIELDS BRUCKHAUS DERINGER

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BRIEFING

# Simplifying pension taxation

The Government's proposals
Employment, pensions and benefits: briefing 104

**Executive summary**

The Inland Revenue's second consultation paper on pensions, published jointly with the Treasury on 10 December 2003, proposes a radical overhaul of the tax rules for pensions. Under the proposals a single simplified set of rules would apply to all pension schemes, replacing the existing set of six approved regimes. The government intends the new structure, if adopted, to be in place by 6 April 2005.

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] This followed its first consultation paper, in December 2002, *Simplifying the taxation of pensions: increasing choice and flexibility for all*.[2] While many of the proposals in the first paper reappear in the second, some have been amended or are new.

The consultation paper invites comments by 5 March 2004. If adopted, the measures would be included in the 2004 Finance Bill and be introduced on 6 April 2005 (A-Day). An announcement will be made in the 2004 Budget as to whether the simplified regime will be introduced. (If not, the current regimes will remain in place.) This is dependent on the National Audit Office's report on the appropriateness of setting the lifetime allowance at £1.4m (see below) and the number of people who may be affected by this.

This briefing looks at the proposals and some of their practical implications.

## Single tax regime

The second consultation paper confirms the intention set out in the first paper to introduce a single, simplified tax regime for all pension schemes, and to replace the existing set of six approved regimes (four for occupational pension schemes and two for personal pensions). Unapproved schemes, ie funded unapproved retirement benefit schemes (Furbs) and unfunded unapproved retirement benefit schemes (Uurbs), will continue subject to some changes: see our briefing *Provision of pension benefits over the lifetime allowance* (number 105, December 2003).

## New tax rules

The key elements of the December 2003 proposals are:

- a single lifetime allowance on tax-advantaged pension savings of £1.4m (price-indexed) – the lifetime allowance;
- a single factor for valuing defined pension benefits against the lifetime allowance of 20:1 at all ages;
- a recovery charge levied at 25 per cent if the lifetime allowance is exceeded (reduced from 33.33 per cent in the first consultation paper);
- the ability to take funds above the lifetime allowance as lump sums, subject to a tax charge of 55 per cent (representing the 25 per cent recovery charge plus a 40 per cent income tax charge on the balance);
- tax relief on a member's contributions up to 100 per cent of UK earnings up to a maximum of £200,000 (price-indexed) – the annual allowance;
- income tax charged at the member's marginal rate on the value of any benefit accrual exceeding the annual allowance (except in the year that the benefits are taken in full, see below);
- a single factor for valuing defined pension benefits against the annual allowance of 10:1 at all ages;

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

[2] See our briefing *Inland Revenue consultation paper on pensions*, (number 84, December 2002).

- maximum tax-free lump sum of 25 per cent of pension savings (up to the lifetime allowance);
- minimum early retirement age increased to 55 from 2010;
- more generous transitional arrangements than originally proposed to protect contributions made and service accrued before A-Day;
- the facility to join any number and any type of pension schemes simultaneously;
- confirmation that Furbs and Uurbs will still be permitted (subject to some changes: see our briefing *Provision of pension benefits over the lifetime allowance* (number 105, December 2003)); and
- replacement of the discretionary Revenue approval of occupational schemes by a registration scheme.

## Lifetime allowance

The December 2003 paper confirms the setting of the lifetime allowance on the total amount of pension savings that can benefit from the tax-favoured regime at £1.4m. This amount is to be indexed in line with the Retail Prices Index (RPI) (rounded up to the nearest £10,000) and is intended to represent the lifetime equivalent of the maximum benefits payable under current Revenue limits, subject to the earnings cap (currently £99,000). In effect, therefore, the current earnings cap is being imposed on all employees, including those currently uncapped. See our briefing *Provision of pension benefits over the lifetime allowance* (number 105, December 2003) for more details on providing benefits above the lifetime allowance.

The government stands by its original views that: the £1.4m is the lifetime equivalent of the current maximum capped benefits; around 5000 people in or previously in a pre-1989 uncapped scheme will have pension funds in excess of £1.4m at 5 April 2005; and around 1000 people a year may be affected by the lifetime allowance who would not have been affected by the earnings cap. This was challenged by many respondents to the first consultation paper. To address this, the government is to ask the National Audit Office independently to review its figures. If the figures are not confirmed, the government states that the tax simplification proposals will not be implemented and the current regimes will remain in place.

Funds will be tested against the lifetime allowance when certain events occur, including when:
- a benefit comes into payment;
- a pension in payment is increased by more than the rate used to value the benefit against the lifetime allowance (except that increases provided to all members of a scheme with at least 50 pensioner members will not have to be tested);
- an authorised transfer is made to a non-registered overseas scheme; or
- the member reaches age 75 with unvested funds.

As a simplification measure, a single standard factor of 20:1 is to be used to value defined benefit (DB) benefits against the lifetime allowance at the time that the benefit vests. This factor assumes that pensions increase in line with RPI and that aggregate survivors' pensions equal to no more than the member's pension are payable on the death of the member. Schemes wishing to offer more generous levels of indexation or survivors' benefits must agree a different factor with the Revenue.

All current Revenue limits, including the earnings cap, will disappear from A-Day. Schemes will need to be reviewed to ensure that this will not result in any unintended uplift in benefits (eg where final pensionable salary is restricted by reference to the earnings cap). We had expected the second paper to propose introducing a statutory limit. However, none is proposed and schemes would be prudent to assess their individual issues even if a global statutory solution were proposed.

## Recovery charge

The value of benefits in a registered scheme will be able to exceed the lifetime allowance (ie there is no benefit limit), but there will be a recovery charge of 25 per cent (originally to have been 33.33 per cent) of the excess at the time the benefit vests.

Benefits in payment from other registered schemes will have to be taken into account in determining the amount of any recovery charge. Schemes will be required to certify to the member the percentage of the lifetime allowance that the vested benefit represents.

### Lump sums

The first consultation paper prohibited the taking of funds in excess of the lifetime allowance in lump sum

form only. The government has accepted comments from many respondents that the purpose of the recovery charge was to put people back in the position they would have been in had they taken taxed salary instead of a pension contribution, and has now conceded that a member may choose to take any part of funds in excess of the lifetime allowance as a lump sum, subject to a tax charge of 55 per cent.

## Annual allowance

The annual allowance, ie the limit on tax-privileged saving (contributions to a defined contribution (DC) scheme and increase in the capital value of benefits (other than death-in-service benefits) accrued in a DB scheme), is confirmed as 100 per cent of earnings up to a maximum of £200,000 a year (indexed in line with RPI and rounded up to the nearest £1,000).

A new easement, however, is that contributions to DC schemes and benefit growth in DB schemes will be exempt from the annual allowance in the year in which the benefit is taken in full. This addresses concerns raised during consultation that the annual allowance could trigger a charge on redundancy or early retirement (particularly in circumstances of ill-health).

A single factor of 10:1 will be used to value the annual increase in benefits in DB schemes.

Certain payments will not count towards the annual allowance:

- personal contributions in excess of 100 per cent of earnings (or £3,600, if higher) because they will not qualify for tax relief;
- age-related NIC rebates to contracted-out money purchase schemes or appropriate personal pension schemes; and
- transfers-in from registered schemes and recognised overseas schemes.

## Contributions

### Tax relief

Tax relief for employers and for employees with earnings chargeable to UK tax will remain the same: employers will receive tax relief on contributions into a registered scheme and employees will receive tax relief on the higher of £3,600 or 100 per cent of UK earnings. There will be no limits on the tax-relieved contributions of current or former employers.

An individual other than the employer or former employer will be able to contribute to a scheme on behalf of the member. This will be treated as a contribution by the member, to whom tax relief will be given.

### AVCs

With a maximum contribution limit of 100 per cent of annual earnings, AVCs may become indistinguishable from ordinary contributions and the Revenue prohibition on taking AVCs as a lump sum will disappear. The requirement for schemes to provide an AVC facility will also go.

Other vehicles may become more attractive. See, for example, our briefing *Pensions: salary and bonus sacrifices* (number 103, December 2003).

### Tax on refunds of contributions

The tax charge payable by a registered pension scheme where an employee leaves Pensionable service after less than two years will be two-tiered: the first £10,800 will be taxed at 20 per cent and any excess will be taxed at 40 per cent. This replaces the current 20 per cent charge on approved occupational schemes.

## Protection of pre-A-Day rights

Pre-A-Day rights may be protected from the recovery charge by registering those rights with the Inland Revenue within three years of A-Day. These include the right to a tax-free lump sum in excess of the new maximum tax-free lump sum.

Individuals who register pension rights valued in excess of £1.4m at A-Day will have the registered value expressed as a percentage of the lifetime allowance (as increased in line with RPI and rounded up where necessary). The example is given of an A-Day value of £2.1m, which is 150 per cent of £1.4m. When the pension vests, benefits can be taken of up to 150 per cent of the then lifetime allowance without incurring tax under the recovery charge.

An alternative method of protecting any pre-A-Day rights (whether or not they exceed £1.4m) is available to

| Value of pre-A-Day pension rights as at A-Day | Personal lifetime allowance (percentage of lifetime allowance) Current position | Amount of lump sum protected from recovery charge |
|---|---|---|
| Up to £1.4m | 100 per cent (ie no increase) | Amount of pre-A-Day lump sum rights as at A-Day increased in line with lifetime allowance |
| More than £1.4m | Percentage which corresponds to value of pre-A-Day fund | Percentage of pension value vesting post-A-Day |

those who, before A-Day, suspend pensionable service and stop contributions: this protects accrued benefits and post-A-Day increases. Active membership of a pension scheme may be resumed at any time before age 75, with the protection set out in the table above.

There will be a cap on pensionable pay in DB schemes for those who register pre-A-Day rights: for those subject to the earnings cap at A-Day it will be 1/14 of the lifetime allowance. For those not subject to the earnings cap, pensionable pay will be unlimited; however, where it exceeds 1/14 of the lifetime allowance, it must be averaged over a period of at least three years before the benefits come into payment.

Pensions already in payment at A-Day will be treated as having used up part of an individual's lifetime allowance where, after A-Day, the individual has a new benefit coming into payment. To calculate the amount of the lifetime allowance used up, such pensions will be valued using a single standard factor of 25:1 (which reflects the fact that people will have taken tax-free lump sums).

## Payment of benefits

### Commutation lump sums

The option of a tax-free lump sum is to be retained to encourage savings in a pension scheme. The maximum will be 25 per cent of the value of a person's benefits up to the lifetime allowance, ie up to £350,000 initially. As noted above, there will be a carve-out for accrued rights to larger lump sums at A-Day.

It will clearly be more attractive to take the lump sum (up to £1.4m) than the taxable income. Schemes may want to change their design accordingly.

## Pension age

The earliest age from which pension benefits may be taken will be 55 by 2010. Schemes may decide how and when to implement this change. The exception to this rule for people in serious ill health remains.

The current earliest retirement age of 50 is protected for individuals with a contractual right before 10 December 2003 to retire at that minimum age, provided that the pension is fully vested when the right to retire early is exercised and the employment terminates before the pension is vested.

The second consultation paper confirms the proposal to abolish the special rules for certain categories of employee, such as professional sportsmen, who currently benefit from very early minimum retirement ages yet frequently embark on a second career and do not retire fully until much later. There is to be transitional relief for those with an existing low normal retirement age at A-Day.

### Pensions to be payable by age 75

Benefits must be in payment by the day before the member's 75th birthday. No capital sums may be paid on death on or after the member's 75th birthday. Many respondents to the first consultation paper objected to this cut-off date. However, the government has retained it on the basis that the tax relief afforded to pension schemes is intended to promote savings for retirement and not the creation of capital wealth.

Pensions may be either unsecured or secured.

### Unsecured pensions

Up to age 75, income may be provided through an unsecured pension, in a similar way to the present facility for income withdrawal.

The minimum annual income will be £1. The maximum income in any year will be 120 per cent of the annual income which would be paid if the funds were used to purchase a flat-rate single-life annuity on the open market. The maximum level of income must be reviewed at least once every five years.

Alternatively, unsecured income may be drawn before age 75 by using part of the fund to purchase term-certain annuities of not more than five years' duration. These cannot be commuted for a lump sum at any time and must not continue beyond age 75.

**Secured pensions**
By age 75, benefits must be secured through:
- an annuity;
- a self-administered pension scheme which contains the necessary rule; or
- alternatively secured income (ASI).

The government explains that ASI has been introduced to meet the objections of some religious groups to mortality pooling. Again, the minimum annual income will be £1. The maximum annual income, however, will be 70 per cent of the annual income that would be paid if the funds were used to purchase a flat-rate single-life annuity on the open market. From age 75, the annuity rate available for a person aged 75 must be used. The maximum level of income must be reviewed at least annually. These requirements are intended to reduce the risk of rapid fund depletion.

## Death benefits

Schemes will be able to pay:
- unlimited tax-free lump sums, subject to the recovery charge; and/or
- taxable pension benefits for survivors.

**Death before drawing any benefits**
Lump sum death benefits will be assessed against the lifetime allowance, with any excess subject to the 55 per cent tax charge.

Where benefits are paid to someone other than the member's legal personal representative(s), schemes must inform the personal representatives of the amount of the lifetime allowance used up by the payment.

Amounts used to provide death-in-service pensions for survivors will not count towards the member's lifetime allowance. This addresses concerns raised during the consultation that death benefits could exceed the lifetime limit, particularly on the death of a young employee. This would have triggered a recovery charge and reduced survivors' benefits.

**Death after drawing benefits**
Different rules for payment of death benefits apply according to whether the pension is unsecured or secured.

**Unsecured pensions**
Any undrawn funds may be:
- paid as a lump sum, subject to tax at 35 per cent (as now); or
- used to provide pensions for survivors.

**Secured pensions**
Where a vested fund or part of a fund is providing secured income for the member, two alternative methods of payment are permitted:
- guaranteed pension – the maximum amount payable to the member as income may be guaranteed to continue for up to 10 years from the vesting date (any remaining instalments must be paid as pension); or
- 'value protection' – on death before age 75, the capital used to purchase the annuity or the amount of the fund which secured the income to be drawn less income already drawn, can be paid as a lump sum subject to tax at 35 per cent.

In addition, a pension may be provided for any survivor(s) but without any guarantee period or value protection.

Where benefits are secured through ASI, any funds remaining on death on or after age 75 must revert to the scheme and can be used to provide survivors' pensions. Where there are no survivors, the funds may be used to provide or augment benefits of any remaining scheme members, to contribute towards a surplus in the scheme or possibly be paid to a registered charity nominated by the member before his death.

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## Flexible retirement

The proposal to allow people to combine work and retirement is confirmed.

## Pension sharing on divorce

The government now proposes to rectify a matter regarded as unjust by many respondents to the first consultation paper. Where a pension sharing order is made on or after A-Day, the amount transferred to the ex-spouse's pension arrangement will count towards the ex-spouse's lifetime allowance and not the transferring member's. Neither pension credits nor pension debits will count towards the annual allowance.

## Investments

There is to be a single set of investment rules for all schemes (with transitional rules to prevent schemes from having to dispose urgently of assets incompatible with the new rules). Subject to DWP requirements, the only prohibitions placed on investments by the Inland Revenue will be:

- loans to members;
- loans to employers (other than bonds issued on the open market);
- shareholdings in the sponsoring and associated employers in excess of 5 per cent of fund value; and
- borrowings of more than 5 per cent of fund value at the date of the loan.

Thus schemes will be able to invest, for example, in residential property.

Any changes after A-Day to the terms of a pre-existing loan will render the whole loan subject to the new rules.

If a member uses a scheme asset on non-commercial terms, he will be subject to a tax charge similar to the existing benefit in kind charge on employees. Examples given are a member living in a residential property owned by the scheme or having a painting owned by the scheme hanging in his house.

## Uurbs and Furbs

As noted above, the second consultation paper confirms that Furbs and Uurbs will continue to be permitted but will not enjoy any specific tax-privileged status. This is because the new regime will allow for unlimited benefits within registered schemes, the only limit being on how much tax relief is given. The effect of the proposals on unapproved schemes is dealt with in our separate briefing *Provision of pension benefits over the lifetime allowance* (number 105, December 2003).

## Registration of schemes

The current system of Revenue approval will be abolished and replaced by a registration process. The Revenue will carry out post-registration checks to ensure that the scheme is complying with the tax rules. Schemes will be selected for audit on the basis of random selection and risk assessment.

Existing approved schemes will automatically be registered under the new system unless they choose to opt out. New schemes will have to complete a declaration that they will comply with statutory requirements. The Inland Revenue will issue an acknowledgment, which must be retained by the scheme. Tax relief will be allowed on pension contributions made after the date that the acknowledgment was issued.

There are also plans to streamline the demand for information associated with registration with the Revenue, with Opra and its successor and contracting-out. Certain events will be reportable on an annual return form.

The abolition of the discretionary approval system may lead to significant changes. It appears to mean, for example, that occupational schemes can admit employees of non-associated companies to membership. This could have serious implications for share and business sales, as it could mean that there is no longer a need to transfer to purchaser schemes.

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