



Simplifying pension taxation

Mainstream design issues for pension schemes



Contents

Introduction	1
Allowance, not limit	2
Effect of removal of monetary limits	2
Limits going forward	3
Vesting age	4
Benefits on death pre-retirement	4
Survivors' pensions	5
Divorce	6
Ill-health benefits	6
Pension increases	7
Tax administration issues	8
Infringing the new limits	8
Tax on benefits over the allowances	8
Member information	9
Process on vesting of pension	10
Other changes	11
Design issues and choices	12

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Introduction

On 10 December 2003 the government published its second consultation document on pension simplification, *Simplifying the taxation of pensions: the government's proposals*. We outlined these proposals in our briefing *Simplifying pension taxation* (no. 104, December 2003). If enacted the government's proposals will replace the existing pension tax rules from 6 April 2005. Many of the changes will allow greater flexibility for schemes not only for high earners (over the £1.4m proposed lifetime allowance) but also for the vast majority of scheme members (for whom the lifetime allowance is not a particular issue). This guide looks at the implications for schemes in relation to 'mainstream' benefit design and administration.

Allowance, not limit

The main simplification envisaged by the proposals is the removal of the current monetary limits on benefits that can be provided by Revenue-approved occupational pension schemes. Instead these monetary limits would be replaced by two new allowances:

- a £1.4m (indexed) lifetime allowance; and
- a £200,000 (indexed) annual allowance.

One of the major changes is that these allowances are *not* absolute limits in the same way as benefits are currently limited by Revenue rules. Schemes are currently prohibited from paying benefits above the limits even if they want to and would be prepared to pay tax on them. If a scheme does this it runs a severe risk of losing its Revenue-approved status.

Conversely, the new allowances are not limits – benefits can be paid (or accrued) at rates greater than the allowances, but there would then be an additional tax charge (based on the 25 per cent recovery charge for benefits over the lifetime allowance).

Obviously the changes are likely to have the greatest effect on high earners whose benefits are now (or may in the future become) greater than the relevant allowances.

For the vast majority of scheme members, however, the lifetime allowances are not likely to be relevant. Instead the simplification proposals would allow much greater flexibility for schemes in the level of benefits that they are able to provide.

This guide looks at the implications of the simplification proposals:

- on benefits for ordinary members; and
- in relation to schemes and their administration.

Effect of removal of monetary limits

Many schemes have their liabilities limited by Revenue limits (eg for capped earners or those up against current Revenue limits). If nothing is done, there is a risk that the effect of the proposed simplification would be a simple removal of those limits, resulting in an increase in the scheme's liabilities.

It would be helpful if the legislation could include a statutory provision to avoid this increase in scheme liabilities following the general removal (on A-Day) of Revenue monetary limits on benefits. A statutory provision on two lines would be helpful:

- that references (in a contract, trust or otherwise) before A-Day to the permitted maximum (commonly called the earnings cap)

should, until amended, be deemed replaced after A-Day by a reference to 1/14th of the lifetime allowance – the second consultation document points the way here; and

- that references (in a contract, trust or otherwise) to Revenue limits (or other limits on benefits) applicable before A-Day will be treated as continuing despite the change in Revenue legislation and practice from A-Day, until amended.

Limits going forward

The monetary limit on the total amount of benefits that can be paid will (as mentioned above) be removed by the simplification proposals. It is important to realise, however, that some limits and restrictions will remain. If these are not complied with the pension scheme will cease to be treated as a registered retirement benefit scheme for tax purposes (with registration to replace the current approval regime from A-Day) and hence lose its tax-favoured status and suffer a tax charge on deregistration.

These limits are set out in the second consultation document:

- there is no maximum pension (instead increased taxation if the capital value of all benefits is over the lifetime allowance);
- the lump sum (below the lifetime allowance) is limited to 25 per cent of the capital value of the benefits (but with some protection for members with an existing right to a greater lump sum on A-Day); and
- pensions are still payable, other than to the member, only to a spouse or dependant (presumably generally only following the member's death).

Pension benefits must:

- start before age 75;
- not start before age 55 (age 50 until 2010) with an exception for ill-health retirement;
- last for the remainder of the person's life (it is not clear whether bridging pensions will still be allowed);
- be paid in instalments at least annually;
- not be assignable to anyone, other than where permitted by Revenue requirements (presumably, as now, as a result of a court order on divorce and a lien in favour of the employer for some liabilities);
- not be guaranteed for a period greater than 10 years;
- up to age 75, not offer a capital guarantee of more than value protection (the lump sum payable, subject to tax at 35 per cent, on

death before age 75, payable from the capital used to purchase the annuity or the amount which secured the income to be drawn less income already drawn);

- lie between certain minimum and maximum income limits; and
- be taxed as income, generally under PAYE.

Vesting age

The age at which benefits can normally be taken is to be increased from 50 to 55 from 2010 (though there will be special rules for schemes currently with low retirement ages). However, it will be clarified that Revenue rules will not require a member taking benefits to retire from current employment (provided he is over 55).

A transitional exclusion is included in the second consultation document. Members with a contractual right to retire before age 55 which existed before the consultation document came out (10 December 2003) may still exercise this after 2010. The pension would have to be fully vested and the relevant employment terminated. Further detail on this is needed eg does a current right subject to employer consent still count?

Benefits on death pre-retirement

There was concern following the first Revenue consultation document, *Simplifying the taxation of pensions: increasing choice and flexibility for all* (December 2002), that current levels of death benefits could, even for relatively low earners, result in benefits exceeding the lifetime allowance. This is because a combination of a four times salary lump sum plus a two-thirds pension for a young spouse could have a value over £1.4m in some circumstances.

The second consultation document addresses this. Pensions payable to a spouse or a dependant of the member following death before vesting (eg in service) will not count towards the lifetime allowance. The income paid to the spouse or dependant will of course be liable to income tax in the usual way.

Lump sum benefits payable by the scheme will still count towards the lifetime allowance.

The actual amount of death-in-service benefits (and benefits on death in deferment) will not be limited (unlike, say, lump sums on retirement (vesting), which are limited to 25 per cent of the fund up to the lifetime allowance but unlimited over that, subject to tax). For low earners, this may mean that it is more advantageous if the death benefit were a lump sum rather than a pension for spouse and dependants (on the basis that the lump sum is tax-free, whereas the pension is subject to income tax).

Conversely, for higher earners (who may be at risk of exceeding the lifetime allowance) it may be more attractive for the lump sum to be limited to the lifetime allowance with any balance payable as pension (on the basis that the pension is not part of the lifetime allowance and so not subject to a recovery charge).

Care will be needed in making any amendments to existing benefits. Although death-in-service benefits are not normally within the definition of 'accrued rights' (and are not protected by section 67 of the Pensions Act 1995), there is still an issue as to the factors and consents that the trustees should seek if they are looking to restructure death in service benefits. In practice, however, it is likely that the informed consent of the member alone (not the spouse or dependants) is sufficient authority here.

Care will also be needed to ensure that the level of pension payable to a surviving spouse remains high enough to comply with contracting-out requirements.

Survivors' pensions

The second consultation document (and indeed the previous consultation document in December 2002) is clear that pension benefits can still be paid only to the spouse or dependant of the member following the member's death. Schemes will not be allowed to pay pensions to non-dependants.

There is still a requirement to show dependency (financial interdependency will be enough). This still means that schemes will be required to check and be satisfied about dependency.

It seems that the current practice of allowing any person or company or organisation to be nominated for a lump sum death benefit will not continue. (The consultation document indicates that the lump sum can be paid only to dependants.)

The consultation document did not deal with the position of proposed registered civil partnerships for same-sex couples, as announced in a consultation document issued by the government earlier in 2003, *Civil Partnerships: a framework for the legal recognition of same-sex couples* (June 2003). The government has still not dealt with the tax position of these proposed registered civil partnerships.

No changes to the inheritance tax (IHT) position are envisaged as part of the current proposals. It is therefore safer to deal with distribution of lump sum death benefits through a discretionary trust on the basis that this clearly removes the amount of the lump sum death benefit from the member's estate for IHT purposes. It may well be possible to give the member a binding nomination right

in relation to lump sums without this adverse IHT tax consequence but the benefit structure would need to be carefully worked out (and any such binding nomination process is inevitably less flexible in dealing with changed circumstances).

Divorce

At present if a pension sharing order is made by a court (on divorce or nullity) the amount transferred from the member is treated as remaining with the member for the purpose of checking the member's Revenue limits.

The second consultation document proposes to change this. The amount transferred will not count towards the member's lifetime allowance. Instead it will, from A-Day, count towards the ex-spouse's lifetime allowance. Neither the debits nor credits will count towards the annual allowance.

For those over or near the lifetime allowance, this may be a (small?) encouragement to divorce so that a couple can take advantage of the two separate lifetime allowances (though to divorce solely for that reason is likely to be fraudulent). There are, of course other implications (not least for IHT). We assume that the Revenue views this as an unlikely loophole.

Pre A-Day credit rights following a divorce will need to be registered (to be taken outside the lifetime allowance). Pre A-Day debits will continue to count towards the member's limits.

Ill-health benefits

Timing

The proposals envisage that it will still be possible to pay ill-health benefits before the usual minimum vesting age (age 50, rising to 55 from 2010).

As now, schemes may, but do not have to, pay early retirement pensions when the member is incapable of continuing his current occupation. However, the member must actually cease working in that occupation to claim the ill-health pension (contrast the proposed normal position for retirement benefits starting after age 50/55).

The trustees will be obliged to obtain medical evidence of the ill health (usually a doctor's certificate) and will need to keep this in case they are audited by the Revenue. Failure to obtain a medical certificate will lead to the benefits being treated as unauthorised payments.

Schemes will still be able to stop an ill-health pension if the recipient recovers.

Total commutation

Occupational schemes will also be able to continue totally to commute all of a member's benefits in exceptional circumstances of serious ill health. This only applies where the individual is considered to be likely to die within the next 12 months. A doctor's certificate evidencing the ill health will be needed.

Amount

Ill-health pensions sometimes envisage benefits being enhanced by prospective service (as well as service accrued to date) and being payable immediately without any actuarial reduction. There had been some concern after the first consultation document that, because such a benefit would in effect give rise to a very large accrual in the year in which the benefit became payable, some ordinary members might therefore be caught by the annual allowance.

The second consultation document deals with this by its general provision that benefit accrual does not count towards the annual allowance in the year in which all benefits from that scheme are taken.

However, paying such benefits in full could still potentially take a member over the lifetime allowance. A check for this will still need to be made. However, it may well be that the commutation factor to be used in all defined benefit (DB) schemes (20:1) will give a low value to an ill-health pension even if it is taken at an early age. The government's proposal is that this 20:1 factor is used at all ages (and this seems to be wide enough to cover early retirement as well as normal retirement).

Pension increases

Guaranteed levels of pension increases (eg fixed 5 per cent or over the Retail Price Index, RPI) need to be factored into checks on the lifetime allowance. Increases above RPI may mean that the Revenue looks for a factor bigger than 20:1. The Pensions Bill 2004 also envisages future changes to the minimum level of limited price indexation (reducing it from 5 per cent to 2.5 per cent).

If pension increases are given after vesting at a rate which exceeds the level envisaged at the time of the lifetime allowance check on vesting, this will count as a new benefit, and a further check against the lifetime allowance may need to be carried out.

However, the provisions of the second consultation document envisage an easement for this. The checks do not need to be done if:

- the augmentation applies equally to all pensioner members in the scheme; and
- there are at least 50 pensioner members.

It is not yet clear whether ‘equally’ means an equal percentage rise or something else. Clearly the intention here is to allow pension increases but only if they benefit a relatively large group. It is unclear (for example) how this would apply if pension increases were given only to one section rather than to all pensioners.

Clearly if benefit increases are to be given and targeted towards low-earning pensioners (eg as part of a surplus package) this could still be done. It is unlikely that such low earners would be concerned about the lifetime allowance.

Tax administration issues

Occupational schemes seeking tax-favoured status will be ‘registered’, not ‘approved’. This means that schemes will have to declare that they will comply with the relevant codified conditions for registered schemes. The Revenue will no longer review the schemes and their benefits to check their criteria for formal approval.

The Revenue will have information powers and will look for schemes to submit particulars and documents within a prescribed period.

Schemes will also be required to make a report about certain events which have occurred in the fiscal year. Examples given are starting winding-up, allowing benefits before age 50 and allowing benefits in kind to be provided.

Infringing the new limits

Sanctions will remain if the ‘hard’ limits retained by the Revenue (eg not paying pension before age 50/55) are broken by schemes.

Unauthorised payments will be taxable at a 40 per cent rate, with a further 15 per cent penalty if the payment is of more than 25 per cent of the fund.

If schemes pay excessive unauthorised benefits too often, they risk having their Revenue preferred status revoked (deregistration). The second consultation document envisages that, where a scheme makes ‘unauthorised payments’ in excess of 25 per cent of the scheme’s asset value, the Revenue may then deregister the scheme (with a consequent 40 per cent tax charge on the value of the fund).

Tax on benefits over the allowances

Annual allowance

Policing the annual allowance will be a matter for individual members, not schemes. However, schemes will no doubt be asked by members for details of the value of any pension accrual during the

year. Members will need this information so that they can fill in their self-assessment tax return. The Revenue envisages a conversion factor of 10:1 being used to convert DB pension into capital sums for this purpose.

The recovery charge is payable when benefits exceed the lifetime allowance. It will be primarily an obligation on the individual member to pay. However, there will also be an obligation placed on schemes to deduct the charge at source.

Gross up?

The second consultation document envisages that schemes will be able to 'gross up' if they want to cover the recovery charge. However, this would greatly increase scheme costs. The consultation document is not clear, but presumably this will be treated as an amendment to the scheme and so normally requires the consent of the employer.

If schemes do not gross up they will need to deduct the amount of the recovery charge and account for this to the Revenue (ie it is an upfront charge payable when benefits vest and not gradually over the period in which benefits are paid).

For defined contribution (DC) benefits this is relatively simple – the scheme merely deducts the recovery charge from the member's account. For DB schemes, the scheme will instead need to reduce the amount of scale benefits payable.

It is to be assumed that a statutory obligation will be placed on pension scheme trustees to make these reductions (ie that the anti-suspension, forfeiture etc provisions in section 91 to 94 of the Pensions Act 1995 will not apply).

In relation to defined benefits, the second consultation document indicates that the rate of pension reduction must:

- apply the same factors as for commutation;
- be equivalent for all scheme members (though, presumably, different factors could be used for different sections or benefits); and
- be actuarially justified.

Presumably it will be a matter for scheme design whether the scheme looks to reduce some benefits ahead of others (eg reduce the member's pension alone leaving spouse pension unreduced?). This choice will need to be subject to any contracting-out requirements.

Member information

Upon joining, members will be required to provide schemes with relevant tax details. This will include full name and national

insurance number or tax references. They will also be required to provide certain information when the pension vests.

Process on vesting of pension

Schemes will need to adhere to the following process.

- Within three months before the vesting date the scheme must value benefits and tell the member the percentage of the lifetime allowance that the benefit will use up (presumably for DC benefits this will be an estimate).
- The member must then certify to the scheme whether he has sufficient unused allowance to cover the amount of benefits to be vested. He must tell the scheme what percentage of the lifetime allowance has already been used up.
- If more than one pension is being vested at the same time, the member will be able to choose which scheme effectively vests first.
- The member will need to supply proof to the scheme of any specific transitional protection he has.
- Excess funds over the lifetime allowance will be subject to the recovery charge of 25 per cent.
- Schemes may allow the member to take the excess over the lifetime allowance as a lump sum. However, this is subject to a 55 per cent tax charge (the net effect of the 25 per cent recovery charge and tax at 40 per cent – it does not seem to be open to the member to claim that he is taxable only at the reduced tax rate).
- If no declaration is provided by the member that he is still below the lifetime allowance, the scheme must assume that the lifetime allowance has been exhausted and pay a pension subject to the recovery charge. This looks to be pretty tough for those members whose benefits are put into payment even though the scheme has not actually had any contact from the member (particularly if the member is a low earner and was not very likely to be anywhere near the lifetime allowance). Schemes will probably want to think about including some sort of deferral mechanism here (until age 75) rather than defaulting to the recovery charge.
- Schemes will then reduce benefits accordingly (unless they gross up – see above).

Where a pension is paid by a scheme, the Revenue envisages that the scheme must tell the member annually what percentage of the lifetime allowance has been used up.

Where only a lump sum has been paid, the scheme needs to tell the member only once that the relevant percentage has been used up.

Other changes

Early leaver refunds

There is to be an increased tax charge on some early leaver refunds. Currently a refund of contributions is taxed at 20 per cent. The proposal is that refunds of over £10,800 be taxed at 40 per cent. Presumably this is designed to prevent members from paying large sums into schemes (up to £200,000 in any one tax year) and then leaving pensionable service and looking to withdraw those contributions the same year.

Existing enhanced tax-free lump sums

Some members have an existing right to a tax-free lump sum of more than 25 per cent of the capital value of their benefits. The amount they have accrued at A-Day can be preserved, but will be indexed only at the same rate as the lifetime allowance (ie any link to final salary will be broken). It does not seem that this right needs to be registered with the Revenue, but it also seems that the protection may be lost on a transfer to another arrangement. The second consultation document refers to protection being lost if the member 'chooses to transfer', so it may be that the right can continue if the transfer is involuntary (eg on a scheme merger).

Additional voluntary contributions (AVCs)/concurrency

Full concurrency is to be allowed. Members will be allowed to keep personal pensions going while they are active members of occupational schemes.

This probably means that there will be no need for schemes to continue to offer AVCs in the future. This is currently a requirement under the Pension Schemes Act 1993, but it was anticipated that this requirement would be removed by the pensions legislation proposed by the Department for Work and Pensions (DWP). (The first version of the Pensions Bill does not do this, however.) Schemes may want to offer this facility in any event.

Small commutation

The rules for small commutations will be relaxed. Trivial commutation up to 1 per cent of the lifetime allowance (initially £14,000) will be allowed, but from no more than one scheme in each 12-month period. Trivial commutation on winding-up is also relaxed. Tax is payable.

Limited price indexation (LPI)

As mentioned earlier, the DWP's proposed pensions legislation also envisages changes to LPI going forward. Again schemes have to consider whether or not to reflect this if they can.

Overseas members

Significant flexibility is also being added regarding overseas members joining UK schemes. Employers may want to consider whether they would look now at including overseas employees in UK schemes. Employees who are currently members of corresponding schemes (overseas schemes which attract relief for contributions because the Revenue is satisfied that they provide corresponding benefits) will be subject to the lifetime allowance.

Design issues and choices

Schemes and employers need to consider the implications for benefit design of this proposed new simplified structure. The following issues arise.

- What is the effect of the removal of the monetary limits?
- What is the effect of the abolition of Revenue limits (and the earnings cap)?
- Should schemes look to change the lump sum/pension mix, particularly on death in service?
- Should schemes allow lump sums to be paid on amounts over the lifetime allowance?
- How will schemes look to deduct the recovery charge?
- Will schemes look to allow income drawdown or alternatively secured income (ASI) in future?
- Employers should check contracts for terms allowing retirement before age 50 after 2010 (and keep evidence of any current contractual right).
- Schemes must consider what commutation rates to use (eg for valuing benefits or deducting the recovery charge).
- Schemes must ensure adequate communication of information to members.
- Schemes must keep appropriate records.

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