



Introduction

The HM Treasury and Inland Revenue consultation paper "Simplifying the taxation of pensions: increasing choice and flexibility for all" was published in December 2002 at the same time as the Pensions Green Paper.

The paper was the culmination of a review launched by the Inland Revenue in March 2001 to tackle the extreme complexity of pension taxation. The review was carried out by Inland Revenue staff working with professionals from the pensions industry.

The consultation paper proposes a radical reform of pension taxation. A clean break is proposed, with the eight existing tax regimes being replaced by a single tax regime.

The eight existing tax regimes are:

- 4 occupational pensions regimes (Old Code pre-1970, New Code Post 1970, 1987 regime and 1989 regime);
- 2 individual pension regimes (retirement annuity and personal pensions); and
- 2 unapproved regimes (funded and unfunded unapproved retirement benefit schemes).

The replacement tax regime will have a single, lifetime, limit for tax advantaged savings of £1.4 million. Contributions across all vehicles will obtain tax relief up to the level of an individual's earnings, subject to an upper limit of £200,000 and retirement benefits may be taken on a flexible basis. The £1.4 million and £200,000 limits will be indexed.

Where pension savings exceed the £1.4m limit then a tax charge will be payable on retirement. There will also be an annual tax charge on any contributions in excess of £200,000.

The tax free lump sum under the replacement regime will be 25% of the value of benefits. There will be no distinction on the origin of benefits, so, for example, Additional Voluntary Contributions (AVCs) and contracted-out benefits will count towards the tax free lump sum.

Retirement benefits will be very flexible. They may be taken whilst still in employment, enabling people to stay in work with reduced hours or responsibilities. They may also be taken in stages. However, from 2010, they may only be taken from age 55 years, rather than 50 years.

For Defined Contribution (DC) schemes, there will no longer be a requirement to buy an annuity by age 75.

The government has confirmed that individuals will continue to receive tax relief on pension contributions at their marginal rate under the new regime.

The proposals give rise to a streamlined regime with considerable flexibility. Most of the current compliance burdens are swept away. *However, there are many technical issues to be resolved.*

It is planned that the new regime will come into force from April 2004 or 2005 (A-day). The government is looking for industry views on the timetable.

Draft legislation should be available during 2003.

This Briefing summarises the key points of the HM Treasury and Inland Revenue consultation paper.

The Pensions Green Paper is considered in a separate Briefing.

Press comment

The consultation paper has been generally well received.

The £1.4 million limit is one area of contention. It is considered by many commentators to be too low, even though the government states that it currently covers over 99% of pension savings.

The transitional provision, which allows the replacement of the £1.4 million limit by the amount of pension savings at A-day, has also been criticised on the grounds that any future accrual of benefits in excess of indexation would be taxed at retirement.

Another concern relates to the indexation of the £1.4 million and £200,000 limits which is likely to be in line with prices, rather than earnings. This is consistent with the current earnings cap but will mean that a growing proportion of the population will find part of their pension benefits taxed.

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Key points

- A radical new regime, removing most of the constraints of the old regimes, and giving employers and pension providers the opportunity to innovate in both DB and DC pension scheme design;
- Lifetime pensions savings limit of £1.4 million (indexed), tested at retirement, with transitional provisions for individuals over that limit on A-day;
- Annual £200,000 (indexed) contribution limit across all vehicles, excluding contracted-out contributions;
- Earliest retirement age increased to 55 from 50 in 2010. Retirement must take place by 75;
- Lump sum of 25% of the amount of pension savings, with transitional provisions for individuals entitled to more than 25% under the old regimes;
- Retirement benefits very flexible. Benefits may be taken in stages and whilst remaining in employment. Limited period and value protected annuities allowed in addition to current annuity options. However, no longer any requirement to buy an annuity by age 75, provided income taken within allowed parameters;
- Death-in-service benefits, including tax free lump sum payments, allowed up to the lifetime pensions savings limit;
- Investment restrictions for SSAs and SIPPs to be brought into line with those for other types of pension arrangement, with transitional rules for investments held at A-day. Investment in own shares will be limited to 5%;
- The government is asking for views on commercial property transactions with an employer, and loans to employers and members.
- There are many technical issues to be resolved. There are significant issues in relation to the valuation of DB benefits.

Background

The current pension taxation rules are extremely complex and impose limits on both benefits and contributions. They restrict choice and flexibility and give rise to anomalies between different types of arrangement. They add significantly to the costs faced by employers, providers and individual scheme members.

The consultation paper proposes a radical new regime with a clean break from the past, although pension rights accrued prior to the implementation date (A-day) will be respected. The same regime will

apply to all types of pension arrangement, giving consistency of approach. It will be accompanied by light touch compliance.

The new regime will give employers and pension providers the opportunity to innovate in both Defined Benefit (DB) and DC pension design.

Lifetime limit

Amount of the limit

The lifetime limit will be £1.4 million and cover benefits from all sources, including benefits deriving

from contracted-out rebates. The limit will be indexed.

The consultation paper suggests that the £1.4 million limit is broadly equivalent to the current cost of buying the maximum pension of 2/3rds of the earnings cap of £97,200, with escalation at Retail Price Inflation (RPI), for a male aged 60 and providing a pension for a surviving spouse. However, the top 10 annuity rates at the end of February 2003 suggest that a figure in the range £1.6m-£1.8m would be more reasonable, assuming a maximum 2/3rds spouse's pension.

The method of indexation is not specified in the consultation paper. We believe that indexation in line with prices is the most likely choice. This would be in line with the level of indexation applicable to the earnings cap.

However, the government is being heavily lobbied for an alternative method of indexation. The most favoured choice is indexation in line with National Average Earnings (NAE). Other suggestions include Bank of England Base Rates (as an NAE proxy) or an indexed-linked gilts model (which would provide a match with the underlying investments of an annuity with RPI escalation).

None of the suggestions for an alternative to RPI make any provision for the effect that increased life expectancy has on pension costs. The assumption appears to be that the government will expect people to retire later if life expectancy increases.

Testing against the limit

Testing against the lifetime limit will be made at retirement. There will be published conversion factors to convert DB pension rights into values. A recovery charge will apply if the value of benefits from all sources exceeds the lifetime limit.

As the new regime allows benefits to be taken in stages and from multiple sources, it will be necessary for each pension scheme to calculate the percentage of the lifetime limit used by a member on the vesting of benefits. This percentage will be reported to the Inland Revenue.

For example, an individual could initially vest benefits of £750,000 at a time when the limit is £1,500,000. The pension fund will report to the Inland Revenue that 50% of that individual's lifetime limit has been used. At a later stage, a further £640,000 could be vested when the limit is £1,600,000. The pension fund will report that a further 40% of the lifetime limit has been used, bringing the total percentage of the lifetime limit used to 90%.

Recovery charge

The recovery charge will be 33 1/3% and will be applied by pension schemes on benefits in excess of the lifetime limit.

The 33 1/3% charge is meant to roughly claw back both the tax relief which would have been given on contributions and the gross roll-up of investment funds.

As an example, if an individual has already used 90% of the lifetime limit and vests a further £920,000 when the limit is £1,700,000, then only £170,000 will be subject to the standard rules. The remaining £750,000 will be subject to tax at 33 1/3%, reducing its value to £500,000. This may be taken as a £125,000 lump sum, with the balance of £375,000 being used to provide pension benefits.

In addition to the 33 1/3% charge, for benefits in excess of the lifetime limit, the Inland Revenue proposes that the lump sum, as well as the pension, will be taxable at the individual's marginal rate. Given that a person whose benefits have exceeded the limit will undoubtedly be a higher rate taxpayer, the total tax charge on benefits will be 60%.

At first sight, the total tax charge does appear to be on the high side. However, it should be remembered that, as well as tax relief to the employee and the effect of gross roll-up, it covers the reduction in National Insurance contributions. So, whilst we believe that there is still a case for a lower rate of recovery charge, we doubt whether the Inland Revenue would accept such a proposition.

An alternative approach which is being put forward by some people is to have a tiered recovery charge, rather than the flat rate recovery charge proposed. The rationale is that if the limit has only just been breached then the gross roll-up effect would be small. A larger breach would imply that the lifetime limit was exceeded some time ago and so the gross roll-up effect should be more significant. We doubt that the Inland Revenue

would accept this alternative, although we do see merit in the proposal.

Transitional provision

Where the combined value of an individual's accrued pension entitlements at A-day is greater than £1.4 million then that A-day value may be taken as the individual's lifetime limit. It will be necessary to register the higher A-day value with the Inland Revenue within 3 years from A-day to take advantage of this transitional provision.

Schemes will be obliged to provide members with A-day valuations of accrued benefits up to the third anniversary of A-day. The value placed on DB accrued pension rights will be based on published conversion factors. DC benefits will be based on the A-day market value. The Inland Revenue is asking for advice on the valuation of with-profit contracts.

The current level of the stock market has given rise to concerns about the use of a snapshot A-day market valuation for DC benefits. If the market has not recovered, some people are suggesting automatically uplifting the A-day values by a set percentage (e.g. 25%) or, possibly, an adjustment based on the level of the market at that time. In addition, an underpinning valuation of the amount of contributions made has been put forward.

The Inland Revenue are looking for a straightforward valuation method for with-profit policies. Some people are putting forward a suggestion of using the A-day surrender value uplifted by a set percentage (e.g. 25%).

Contributions

Annual limit

The annual contribution limit will be £200,000 and will apply to the aggregate contributions across all schemes. The annual contribution limit, unlike the lifetime limit, will exclude contracted-out rebates. It will be indexed in the same way as the lifetime limit, probably in line

with prices. As the government points out the limit is very high compared to the maximum limit under a personal pension subject to the earnings cap of currently £38,880.

The government proposes that contributions can only be made by or for people under age 75. This would not prohibit an employer from making general discretionary indexation increases to the pensions of retired employees over age 75 but would potentially restrict that employer from making other enhancements e.g. a one-off increase to an individual pensioner's entitlements on the grounds of hardship or to distribute a scheme surplus. This does seem rather harsh.

The new rules will treat any contributions, other than those made by a current or former employer, as an individual's own contributions.

Tax relief

Tax relief will be available at an individual's marginal rate of tax up to the level of an individual's annual earnings or £3,600 gross, if higher.

Current and former employers will get automatic relief without limit, except for contributions for directors and connected persons, where the normal rules on deductions will apply.

Where an employer operates a scheme solely for its staff then tax relief will normally be through PAYE under the net pay arrangements. However, there will now be an option for an employer to provide basic rate tax relief at source, rather than operating the net pay arrangements.

All other schemes will give basic tax relief at source with individuals obtaining any higher rate tax relief through their self-assessment (SA) returns.

For personal pension and retirement annuity contracts, carry back and forward of unused relief will no longer be available. Carry

forward had, in any event, already been abolished for personal pensions.

Assessment of the amount of contributions

The amount of contributions will be assessed by adding all DC contributions from all sources to the increase in value of DB pension rights. Any excess over the annual limit will be entered on an individual's SA tax return.

The increase in the value of DB pension rights will cover:

- Any increase in the value of rights under a scheme operated by a current employer;
- Increases in deferred DB benefits from a former employer in excess of any statutory revaluation, or NAE, if higher; and
- Discretionary increases in pensions in payment in excess of indexation.

There will be published factors to place a value on increases in DB pension rights. However, the consultation paper says that these will be used as a "filter". In the event that the annual limit is exceeded using the published factors then the individual has to obtain from his scheme a specific personalised valuation.

Tax charge on contributions above the limit

Where contributions, taking into account specific personalised valuations, exceed the limit then the excess will be treated as a benefit-in-kind and taxed at the individual's marginal rate.

The purpose of the tax charge on contributions above the limit is to guard against tax leakage. In theory, it is not needed because of the recovery charge on benefits in excess of the lifetime limit. For benefits which are also taxed under the lifetime limit, it will give rise to a very penal level of taxation.

There are specific concerns about the charge in relation to DB schemes where an individual with a large number of years' service receives a substantial pay increase. This could trigger a tax charge which the individual might find it hard to meet out of income (and which would relate to a "promise" to pay benefits from a DB scheme rather than an absolute guarantee).

The Inland Revenue has indicated that in the year where retirement benefits are vested it might be willing to exclude the benefits being vested from the annual contribution calculation. More generally, it has also indicated that it would be willing to consider an alternative to the charge which is as effective in stopping tax leakage.

Retirement age

Earliest retirement age

The government proposes increasing the earliest age for retirement from 50 to 55 years from 2010. The new retirement age of 55 will apply to everyone. The previous ability for sportsmen and others to take pensions from a much earlier age will be removed.

Transitional provision

The government proposes that members of the armed forces, police and fire service should be allowed to retain the right to draw their accrued entitlements before age 55. It asks whether there are any other groups of people who should benefit from this transitional provision.

Latest retirement age

Benefits must be vested by age 75.

Flexible retirement

Between the earliest and latest retirement ages, benefits may be taken on a flexible basis. They may be taken in stages and whilst remaining in employment.

Ill-health retirement

Earlier retirement on the grounds of severe ill-health will be permitted.

Lump sum on retirement

Amount of lump sum

On retirement, 25% of the value of benefits from all sources, including contracted-out benefits, will be able to be taken as a lump sum.

The lump sum will be tax free provided the benefits being vested are within the lifetime limit. Where the lump sum relates to benefits above the lifetime limit then it will be taxed at the individual's marginal rate.

Transitional provision

Where an individual's pre A-day accrued entitlement to a lump sum is greater than 25% of the value of (pre and post A-day) benefits then the transitional provision allows the pre A-day entitlement to be as the lump sum.

In making the comparison, the pre A-day accrued entitlement is indexed from A-day to the date of retirement.

The government has allowed two options for the calculation of the pre A-day accrued lump sum entitlement:

- An exact valuation which has to be carried out within three years of A-day; or
- 3/80ths for each year of service multiplied by P60 earnings in the tax year prior to A-day and, where relevant, capped according to the tax regime applying to the individual's current pension scheme.

Serious ill-health commutation

In the event of serious ill-health, people under 75 years old will be allowed to take the whole of their unvested pension rights as a tax free lump sum.

Trivial commutation

An individual with pension rights valued at less than £10,000 across all schemes will be able to take all their benefits as a lump sum. The first 25% will be tax free. The remainder will be taxed as income.

This option will only be available once. So, if further pension rights are accrued after taking a trivial commutation then these rights will have to be taken using the standard rules.

Retirement income

Income rules

Once any lump sum has been taken, the balance of a fund will have to be used to provide a retirement income for the person. The rules will allow considerable flexibility in the form of retirement income. The rules on retirement income are as follows:

- The income must last for the remainder of the person's lifetime and be payable in instalments no less frequently than annually. The income may be guaranteed for a period of up to 10 years;
- If the income is secured by a pension scheme or an annuity, there will be no restrictions on the amount of income;
- Where the income is unsecured, it must be at least £1 per annum and no more than the maximum income that could be secured by purchasing an annuity in the open market. The level of unsecured income must be market-tested every 5 years prior to age 75 and annually thereafter;
- Income will be non-assignable other than to permitted beneficiaries; and
- It will be taxed under Schedule E with providers deducting tax under PAYE.

Death after retirement

On death after retirement, the following options will be available:

Death before age 75

- A lump sum, taxable at 35%, of no more than the value of vested funds less the income payments made prior to death; and
- Taxable income benefits to survivors and dependants.

Death on or after age 75

- Taxable income benefits to survivors and dependants; or
- If there are no survivors or dependants, the funds will revert to the provider.

New annuity options

The new rules will allow 2 new types of annuity:

- Limited period annuities where an individual uses part of their pensions savings to buy, for example, a 3 or 5 year annuity; and
- Value protected annuities where a death benefit will be available up to age 75 of the difference between the purchase price and the annuity payments made.

Death before vesting

In the event of a person dying before their benefits have vested then the following benefits will be available after the deduction of the 33% recovery charge on any funds in excess of the lifetime limit:

- An unlimited tax free lump sum; and/or
- Taxable income benefits to survivors or dependants.

Life assurance policies may be used to provide lump sum death benefits. In assessing the lifetime limit, their proceeds will be added to the total value of the fund.

DB valuation factors

Factors will be used to value DB pension rights in the following circumstances:

- On vesting, to calculate the maximum lump sum available

and to test against the lifetime limit (“lifetime limit factors”);

- Under the transitional provisions, to determine the value of accrued DB pension rights at A-day for individuals whose rights exceed the lifetime limit of £1.4 million (“transitional factors”); and
- To test increases in DB pension rights over the tax year which might cause the £200,000 annual contribution limit to be breached (“annual limit factors”).

The government proposes a simple, stylised, approach for these factors. The factors will be set by order and will be reviewed and updated, where necessary, perhaps at intervals of 3 to 5 years. They will not accurately reflect current market valuations.

We will look at the factors for each of these areas in turn.

Lifetime limit factors

The government’s initial proposal is that lifetime limit factors should be unisex, assume a survivor’s pension of half the member’s pension and allow for RPI indexation (implying a discount rate in payment based on index-linked gilts yields). The government proposes that the factors are age-related. On this basis, the factors would currently result in a multiplier of around 20 at age 60, reducing to around 17.25 at age 65.

The Inland Revenue would need to agree the terms of any valuation not carried out in accordance with the standard tables e.g. because the benefits were considerably out of line with the standard assumptions.

Transitional factors

Current thinking is that the approach could be along the following lines:

1. Multiply the pre A-day accrued pension by the lifetime limit factors which would apply at the person’s normal retirement age; and

2. Discount the number obtained in 1. for the period from A-day to normal retirement age at, say:

- (a) 0% per annum for salary related benefits from a current employer’s scheme;
- (b) 2% per annum for preserved pension benefits subject to increases in deferment (whether on a guaranteed or discretionary basis); and
- (c) 5% per annum for preserved pension benefits not subject to any increases.

This approach makes no explicit allowance for mortality in deferment.

The general consensus is that the transitional factors should be reasonably generous.

Annual limit factors

The annual limit factors could be calculated on a similar basis to the lifetime limit factors. However, as the annual limit factors are for filtering purposes an even simpler approach is likely.

Possible options are:

- A single multiplier e.g. multiply the increase in pension by 20; or
- Multiply the increase in pension by the lifetime limit factor that would apply at the person’s normal retirement age.

Where the filter shows that the annual contribution limit may have been exceeded then the individual will have to get accurate information from their pension scheme on the increase in value of their pension rights. The scheme will provide the person with the transfer value of the increase in pension rights calculated on a scheme-specific (cash equivalent) basis.

The government says that it would be good practice for DB pension schemes to provide annual statements to employees on the increases in their pension rights. However, this will not be mandatory. As a result, there is some concern that employees could

have difficulty filling in their SA tax return.

One suggestion that has been put forward to reduce this problem would be to have a de minimis limit so that people with P60 earnings of less than, say, £50,000 in the tax year would be excluded from the annual contribution limit test.

Potential anomalies

The use of standard factors will give rise to anomalies between DB and DC arrangements, both in relation to the maximum benefits available within the lifetime limit and the amount of the lump sum available.

There will need to be rules on the calculation of reduced DB pension rights when a lump sum is taken. At present, most DB schemes do not reduce the spouse’s pension when the member takes a lump-sum. To use the standard valuation factors to work out the reduced pension would be overgenerous, as they include the value of a 50% spouse’s pension.

Other issues

Scheme providers and approval of schemes

The government is proposing that employers and financial institutions should be permitted providers. It is asking for views on other possible providers e.g. trade unions, professional bodies or affinity groups could potentially wish to set up schemes.

Schemes will be required to register with the Inland Revenue (in much the same way as ISA managers do at present). In future, the Inland Revenue will not approve pension scheme rules, although it will be willing to give guidance. Auditing will pick up and correct errors.

The Inland Revenue proposes to remove the ability of life assurance companies to provide individual policies which are not subject to the rules of a pension scheme. In future, contracts such as Buy-Out and Hancock policies will need to be subject to the rules of a pension

scheme set up by the life assurance company.

Reporting

The following information is likely to form the core of annual reporting to the Inland Revenue:

- Data on each scheme member including name, address, National Insurance number, sex and date of birth;
- Whether the member is resident and employed in the UK;
- The amount of contributions obtaining tax relief at source;
- Details of vested benefits; and
- Details of transfers out of the scheme into schemes without a UK resident administrator.

SSASs and SIPP

The government propose to bring the investment restrictions for SSASs and SIPP into line with those for other types of pension arrangements. A transitional provision will apply regarding the investments held at A-day to prevent forced disposal. These investments will be allowed to run their course.

As a result of these changes, future investment in shares of an employer will be limited to 5%.

Review of investment restrictions

The government is asking for views on the restrictions that should apply on commercial property transactions with an employer and loans to members and employers.

This review could open up loans to members which are a popular feature of US 401k plans.

We believe that commercial property transactions with an employer, which are a common feature of SSASs, will be allowed under the new regime, although appropriate controls will be required.

Non-UK residents

The proposed contribution rules will allow a person who is a non-UK resident to contribute to UK based pension schemes. However, no tax relief will normally be available to such a person. The only exception will be where the person was resident or had chargeable earnings in the UK in any of the previous 6 tax years, in which case £3,600 (gross) may be contributed to pension schemes which offer tax relief at source.

Employers will be allowed to make contributions in respect of non-UK residents. These contributions will attract tax relief in full provided the employer is UK resident.

Simultaneous vesting

The government is asking for views on the protocols to be established between pension providers in the event of the simultaneous vesting of benefits e.g. does one scheme take the lead and from which scheme(s) does the lump sum come from or does the 25% limit apply to each and every scheme?

FURBS

The government proposes that Funded Unapproved Retirement Benefit Schemes (FURBS) will not be able to offer tax free lump sum benefits after A-day. All pension rights from such schemes will be taxable in future. An existing FURBS which converts to the new regime at A-day will have its tax free lump sum rights respected.

Scheme opt-out

All schemes will be allowed to opt out of the new regime. Where they do so, they will be treated as FURBS in future and subject to the post A-day rule that all pension rights will be taxed on vesting.

UURBS

It is not clear how Unfunded Unapproved Retirement Benefit Schemes (UURBS) which do not convert to the new regime will be treated in future. The Inland

Revenue's main concern about UURBS has been the avoidance of National Insurance contributions.

Retirement annuity contracts

The government proposes that in future pensions from retirement annuity contracts will be subject to tax under Schedule E with tax deducted by the provider under PAYE. They are currently taxed under Schedule D with basic rate tax being deducted at source.

Pension scheme surpluses

As there are no benefit limits under the new regime, it will no longer be possible for a surplus to arise in a DC scheme.

For DB schemes, a surplus could still arise where the scheme had assets that were more than sufficient to meet its foreseeable liabilities. Subject to the scheme rules, a DB scheme will still be able to return a surplus to the sponsoring employer in such circumstances. A 35% tax charge will continue to apply.



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