

Pensions Green Paper

Individuals with substantial pension funds or benefits will need to plan their affairs with care in the run up to and beyond the effective date of proposed new pensions legislation, 6 April 2004 ("A-day"). Consistent with their aim of redistributing wealth, the Government plans to tax the profits on large pension funds after A-day, at a rate of one third of growth achieved above an inflation allowance.

"Large" will be defined as the higher of £1.4million or the value of existing pensions at A-day, including those already in payment, which will be capitalised to determine their present value. If all benefits are taken prior to A day the proposed legislation will not apply.

A summary of the Green Paper proposals is set out overleaf.

The good news is that broadly speaking higher rate tax relief on contributions and the ability to take a lump sum of up to 25% of the fund will continue, although the fund to which the percentage may be applied will be restricted to the lifetime limit. For some members of occupational schemes and holders of retirement annuity policies, the tax free lump will increase under the new legislation.

For high earners, the new rules effectively remove the earnings cap and accelerate dramatically the rate at which a substantial pension fund may be accumulated.

Our general advice is that contributions should continue to be maximised prior to A-day, particularly where funds already exceed the £1.4million limit or could do so by A-day, in order to establish the highest possible lifetime limit. Those over age 50 may wish to take benefits from their pension portfolio prior to A-day in order to avoid the proposed recovery charge on subsequent growth.

It will no longer be necessary to purchase an annuity at age 75, but the death benefits from income drawdown plans commencing at age 75 will be limited to provision for spouse's/dependants' pensions. When these benefits cease it seems that any remaining fund will be forfeited.

The Open Annuity, launched last year, permits a return of any remaining annuity fund on death and will, we believe, be attractive for those whose priority is to maximise death benefits.

Abolition of the withdrawal allowance for investment bonds

The pre-Budget report proposed the abolition of the 5% per annum allowance, which is seen as a benefit only to higher rate taxpayers. The Inland Revenue is currently consulting on the impact of these recommendations before reporting to ministers ahead of any announcements in this year's Budget. Any changes are not expected to apply retrospectively.

The current regime allows investors to take an "income" of up to 5% per annum of the original investment, which is not classed as income for tax purposes. This may continue until the capital is deemed returned i.e. after 20 years at 5% per annum. The equivalent of basic rate tax is paid by the fund, but higher rate tax is deferred, and might be avoided if the bond is encashed when the investor no longer pays higher rate tax.

The "5%" facility can be particularly useful when such bonds invest in higher yielding assets such as corporate bond or property funds, where the income produced would otherwise be liable to higher rate tax. Equity funds may be selected as appropriate. Switches between funds do not trigger capital gains tax on any profit that is crystallised.

Those wishing to establish a bond before any change in the rules but who are nervous of markets can initially select low risk deposit or fixed interest funds. The withdrawal facility of up to 5% per annum can be selected at outset or at a future date.

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Regulated by the Financial Services Authority.

This note is for general guidance only and represents our current understanding of law and Inland Revenue practice as at March 2003. We cannot assume legal liability for any errors or omissions and detailed advice should be taken before entering into any transaction. The value of investments and any income from them may go down as well as up and you may not get back the full amount you invested. Levels and bases of, and relief from, taxation are those currently applying but are subject to change and their value depends on the individual circumstances of the investor. For income drawdown policies, it should be noted that: high income withdrawals may not be sustainable during the deferral period; taking withdrawals may erode the capital value of the fund, especially if the investments are poor and a high level of income is being taken - this could result in a lower income when the annuity is eventually purchased; annuity rates may be at a worse level when the annuity purchase takes place, and a certain investment return is required simply to "keep pace" with an annuity, because a pension withdrawal fund does not receive a benefit from the early death of other pensioners, "mortality drag", as does an annuity.

With Profits funds

A number of companies have declared zero or very low reversionary (annual) bonus rates for 2002. Terminal bonuses have continued to fall and market value adjusters, the penalty for leaving a with profits fund early at a time of depressed markets, are rising.

It is important to review with profits holdings in detail to evaluate whether opportunities remain to exit funds at above "asset share" or if, in fact, policy guarantees are assuring reasonable rates of future return.

Venture Capital Trusts

Those fortunate enough to have capital gains to shelter, perhaps because of selling second properties into the buoyant housing market, should consider investing in VCTs. A married person with capital gains to shelter could earn 5.8% per annum net in a VCT after 3 years even if the share price fell by 50%. Please contact us for details of the calculation and current VCT issues.

4 April Deadline

The last working day of this tax year is 4 April, so please remember to review ISA, personal pension* and additional voluntary pension contributions before then, since allowances may not be carried forward.

With the proposed A-day looming, retirement annuity policyholders are reminded that contributions paid before 4 April 2003 may be elected back to the 2001/2 fiscal year. Where unused relief exceeds normal annual earnings and contributions are to be maximised before A-day, it may be necessary to spread contributions over more than one tax year to maximise income tax relief. There will be only two tax years to choose from for contributions paid after 4 April.

Review Pension Linked Life Cover

The Green Paper proposes to include pension term assurance cover in the calculation of death benefits that can be paid free of tax. Any death benefit in excess of the lifetime limit will be subject to the recovery charge.

Those with "Section 226a" or "Section 637" term assurances should consider replacing them with non-pension linked term assurance. Some policies contain a conversion option, but for those who are in good health, a new application to a competitive provider may secure a lower premium.

*personal pension contributions paid after 4th April 2003 but before 31 January 2004 may however be elected back to the 2002/03 fiscal year.

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Green Paper - Summary of Main Proposals

General

- Replace the current eight pension regimes with one from a date suggested to be 6 April 2004
- Limit tax privileges to a lifetime pension fund of £1.4 million and an annual contribution limit of the lower of £200,000 or 100% of earnings, although contributions of £3,600 per annum are permitted even with no earnings - both limits indexed thereafter
- Allow pension rights built up before A-day beyond the lifetime limit to be protected and indexed
- Permit further contributions with tax relief after the lifetime limit of £1.4 million is reached
- Introduce a recovery charge of one-third of the excess of the pension fund over the lifetime limit (£1.4 million or the protected fund if greater) before benefits can be drawn
- Tax due on excess funds to be accounted for through self assessment but paid from the pension fund
- Allow a lump sum of up to 25% of the value of the matured pension fund to be drawn tax free up to the lifetime limit (and taxable thereafter)
- Abolish carry forward/carry back rules for retirement annuity policies and carry back rules for personal pension plans
- Include contributions into defined contribution schemes and the increase in the value of defined benefit pension rights in the assessment of the annual limit
- Publish Inland Revenue actuarial tables to determine the capital value of defined benefit pension benefits (including pensions in payment) for the purposes of testing the £1.4m limit and the £200,000 increase in value
- Allow contributions to occupational and personal schemes at the same time
- Count national insurance rebates for benefit but not contribution limits

Drawing Benefits

- Allow schemes to stagger vesting up to age 75
- Require mandatory vesting of pension funds by age 75 to provide an income although no requirement to purchase an annuity at any age
- Income drawdown maximum income calculation similar to now, but minimum reduced to £1 per annum with maximum limit reviewed at least every five years up to age 75 and annually thereafter
- Use remainder of pension fund (even if lifetime limit exceeded) to provide pension income when lump sum has been drawn
- Raise minimum benefit age from 50 to 55 by 2010
- Allow the drawing of benefits whilst continuing to work for same employer
- Continue provision for ill health pensions before age 55
- Introduce "limited period" and "capital protected" annuities.

Death Benefits

- Make benefits on death before vesting consistent for all schemes
- Allow lump sum death benefits before vesting up to age 75 to be tax free up to the lifetime limit and subject to the recovery charge thereafter
- Allow lump sum death benefits after vesting up to age 75 to be no more than the value of the fund used to provide the pension income less pension payments paid less 35% tax charge (will not apply to people drawing income prior to A-day)
- Allow taxable income benefits for survivors or dependants
- Include pension term assurance cover in the lifetime limit calculation
- Test funds providing death benefits against the lifetime limit