

PROPOSED PENSION RULES - UPDATE

Following our October 2010 Client Briefing Note, HM Treasury has now published draft legislation for the 2011 Finance Act, which includes details of the pension contribution and compulsory annuity purchase abolition rules that will apply from 6 April 2011. Details of the reduced lifetime pension fund allowance that will apply from 6 April 2012 are also included in the draft legislation. The intention of this note is to update you on the proposed changes and provide our comments and general guidance.

The Proposed Rules		Comments and General Guidance																					
1. Contributions																							
1.1	The annual allowance, which restricts an individual's total pension input, is confirmed as £50,000, from 6 April 2011. Where an individual's total pension input exceeds the annual allowance, they will be subject to a tax charge of 40% on the excess.	<p>Higher rate and additional rate taxpayers should maximise pension contributions, subject to total pension benefits not exceeding, nor being likely to exceed, the lifetime allowance (see section 2).</p> <p>Additional rate (50%) taxpayers are able to create an income producing pension fund at a cost of only 33p in the pound (see example below based on a gross contribution of £10,000). The equivalent figure for a higher rate (40%) taxpayer is 47p in the pound, and for a basic rate (20%) taxpayer it is 73p in the pound.</p> <p style="text-align: center;">33p in the £</p> <table border="1"> <thead> <tr> <th></th> <th>Cost</th> <th>Benefit (amount in pension fund)</th> </tr> </thead> <tbody> <tr> <td>Gross amount</td> <td>£10,000</td> <td>£10,000</td> </tr> <tr> <td>Tax relief at 50%</td> <td>-£5,000</td> <td></td> </tr> <tr> <td>Net cost</td> <td>£5,000</td> <td></td> </tr> <tr> <td>Tax free cash*</td> <td><u>-£2,500</u></td> <td><u>-£2,500</u></td> </tr> <tr> <td>Final cost/benefit</td> <td>£2,500</td> <td>£7,500</td> </tr> <tr> <td>Equivalent to</td> <td>33p</td> <td>£1</td> </tr> </tbody> </table> <p>* There will of course be a timing difference between the date that a contribution is paid and when the tax free cash sum is received. This example illustrates the overall tax efficiency and therefore excludes the effect of charges and investment gains/losses.</p> <p>Those with personal or employer funded regular contributions/benefits exceeding £50,000 per annum should review their arrangements immediately, so as not to exceed the new annual allowance. Pension input period dates should also be checked, since these are independent of fiscal years, and it is technically possible for contributions paid in the 2010/11 fiscal year to utilise the annual allowance for 2011/12.</p>		Cost	Benefit (amount in pension fund)	Gross amount	£10,000	£10,000	Tax relief at 50%	-£5,000		Net cost	£5,000		Tax free cash*	<u>-£2,500</u>	<u>-£2,500</u>	Final cost/benefit	£2,500	£7,500	Equivalent to	33p	£1
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1.2	Tax relief at an individual's marginal rate (for example 50%) can be claimed on personal pension contributions of up to 100% of earnings. Tax relief at a minimum of 20% is available on contributions of up to £3,600, regardless of earnings.																						
1.3	Unused allowances (of up to £50,000 per annum) may be carried forward for up to three years, backdated to the 2008/9 fiscal year, provided the individual held a pension policy during the year for which carry forward is claimed. Contributions will first use the annual allowance for the year of payment, and then the earliest unused year.																						
1.4	By manoeuvring pension input periods, it may be possible to bring forward the annual allowance of up to £50,000 from the next fiscal year to the current one. For example, on 7 April 2011, the 2012/13 allowance could be used.																						
1.5	Depending on the level of carried forward relief, a contribution of up to £250,000 may be paid in 2011/12, if the 2012/13 annual allowance is also brought forward into 2011/12.																						
1.6	The exemption which permitted unlimited contributions to a pension policy in the year that pension benefits are fully vested is to be removed.																						
1.7	For defined benefit pension schemes, increases in pension rights will be multiplied by 16 (previously 10) to determine the annual allowance used in a year. For example, an individual earning £156,250 accruing pension of 1/60th of salary for each year of service will use up the annual allowance (£156,250 x 1/60 x 16 = £50,000), ignoring any increase in salary. Increases in deferred benefits provided because of inflation will not count towards use of the annual allowance.																						

Individual advice should be sought before entering into any transactions, and we will contact clients where and when appropriate. We will also provide an update with any changes, once the draft legislation has been enacted in the Finance Act 2011.

If you would like advice on any of the matters in this bulletin, please contact Nick Fletcher, Chief Executive, at nick.fletcher@saunderson-house.co.uk or on 020 7315 6504 (direct).

2. Lifetime Allowance	
2.1	The lifetime pension fund allowance will reduce from £1.8 million to £1.5 million from 6 April 2012, with no current plan for indexation.
2.2	Pension benefits paid that exceed the lifetime allowance will continue to be taxed at 55% if paid as a lump sum (for example, unvested lump sum death benefits) or 25% if drawn as income.
2.3	Individuals with Primary and/or Enhanced Protection will retain their protection from excess lifetime allowance tax charges.
2.4	There will be a new "Fixed Protection", which must be claimed by 5 April 2012 (where appropriate). This will permit a lifetime allowance of £1.8 million provided no pension contributions are paid, nor benefits accrued in defined benefit schemes (exceeding inflation increases for deferred benefits), after 5 April 2012. Fixed Protection will be suitable for those whose pension benefits already exceed £1.5 million, or are expected to do so, allowing for future growth.
2.5	Fixed Protection will not be available to those with Primary and/or Enhanced Protection.
2.6	The valuation factor for defined benefit schemes will remain at 20 times the initial pension plus any lump sum.
<p>Advice should be sought about (i) managing pension funds within the lifetime allowance, and (ii) the level of pension contributions that should be paid to avoid unnecessarily incurring a lifetime allowance tax charge.</p> <p>It may become appropriate to focus the pension fund on lower risk, lower return assets while holding higher risk, higher return assets outside the pension fund to maintain a balanced overall portfolio.</p> <p>Estimates of future pension benefits should be undertaken during 2011 to determine whether Fixed Protection should be sought. Applications should be lodged with HMRC before 5 April 2012 where applicable.</p> <p>We will be in contact with clients at their next review to provide the relevant advice and Fixed Protection application forms, as appropriate.</p>	
3. Pension Death Benefits	
3.1	Where no pension benefits have been taken (i.e. unvested), pension funds paid as lump sums on death before age 75 will continue to be entirely free of tax, provided they do not exceed the lifetime allowance or relevant protected amount (see 2. above), and do not fall into the member's estate.
3.2	Where pension benefits have been taken (i.e. vested), and after age 75 in any event, pension funds paid as lump sums on death will be subject to 55% tax. This contrasts with the current rate of 35% where death is before age 75 and c82.5% thereafter (note: many providers do not currently permit lump sums on death after age 75, but this is expected to change).
3.3	From 6 April 2011, where there are no living financial dependants, drawdown pension (i.e. vested) death benefits may be paid as a lump sum to charity, free of tax; unvested pension death benefits may be paid tax free to charity even if there are surviving dependants.
3.4	From 6 April 2011, the rules which made pension death benefits potentially subject to inheritance tax, if an individual omitted to take pension benefits when in severe ill health, are to be removed.
<p>Drawdown pension death benefit nominations should be reviewed before 6 April 2011.</p> <p>Those under age 75 face a higher tax charge on drawdown pension death benefits paid as a lump sum. It may be preferable for a surviving spouse or financial dependant to withdraw funds in the form of an income rather than as a lump sum. Where there is a surviving spouse, arrangements that force the payment of residual funds to a separate trust should also be reviewed.</p> <p>Those over age 75, who have nominated charities to receive residual pension funds on the death of a surviving spouse (or themselves where single), will now be able to nominate specified individuals instead, and may wish to review nominations.</p> <p>Where we have not already done so, we will contact clients before 6 April 2011 to provide any recommended actions in light of the new rules.</p>	

4. Tax Free Lump Sum (technically known as Pension Commencement Lump Sum)	
4.1	A tax free lump sum of up to the lower of 25% of (i) pension benefits or (ii) the relevant lifetime allowance will continue to be available. Those with Enhanced, Primary or Scheme Specific Protection may be entitled to higher tax free lump sums.
4.2	Tax free lump sums can, from 6 April 2011, be drawn after age 75, but if deferred and then subsequently paid as a lump sum death benefit, will be subject to 55% tax (unless paid to charity).
<p>Tax free lump sums should generally be taken before age 75 to reduce the tax charge on death.</p> <p>Tax free lump sums withdrawn from the pension will be subject to maximum inheritance tax of 40% (under current legislation), compared to a 55% tax charge on death if retained in the pension fund and paid out as a lump sum death benefit after age 75.</p> <p>We can advise when lump sums should be withdrawn in the context of your overall financial position, which should include estate planning objectives, where appropriate.</p>	
5. Abolition of Compulsory Annuity Purchase Requirement and Revised Pension Drawdown Levels	
5.1	From 6 April 2011, the requirement to buy an annuity at age 75 (or enter into the restricted alternatively secured pension arrangement) will be abolished.
5.2	Arrangements whereby pension income may be withdrawn directly from a pension fund, which remains invested, will be known simply as “drawdown pension” arrangements (including existing unsecured pension and alternatively secured pension arrangements).
5.3	The maximum rate of drawdown pension, for new arrangements from 6 April 2011, will be 100% of the comparable annuity rate set by the Government Actuary’s Department. This contrasts with 120% of the comparable annuity rate for current unsecured pension arrangements and 90% of the comparable annuity rate for current alternatively secured pension arrangements. The minimum rate of withdrawal will be nil.
5.4	From 6 April 2011, the maximum rate of withdrawal for new drawdown pension arrangements will be reviewed triennially (previously quinquennially) up to age 75 and annually thereafter (no change).
5.5	Existing maximum withdrawal levels of unsecured pension arrangements will be brought into line with the new rules by the earlier of (i) the fifth anniversary of the last review or (ii) the first anniversary of the last review following transfer to another provider or attaining age 75. Income levels may therefore reduce.
5.6	Existing maximum and minimum withdrawal levels of alternatively secured pension arrangements will be brought into line with the new rules at the first review following 6 April 2011, and the maximum income may increase.
5.7	From 6 April 2011, drawdown pension levels will be uncapped for those with secure pension income of at least £20,000 per annum. Secure pensions include State pensions, most employer pensions and private pension annuities.
<p>The purchase of an annuity should be avoided in many typical client circumstances.</p> <p>Apart from any spouse’s pension and guarantee period, annuities are not heritable and are generally to be avoided, except where highly favourable guaranteed annuity rates or amounts apply. Annuities providing a spouse’s pension reduce the annuity rate, and are an unproductive use of capital in the event of the spouse’s prior death.</p> <p>A further disadvantage of an annuity is that it is effectively a fixed interest investment. It is unlikely therefore to mitigate inflation over the longer term (except for index-linked annuities, which provide a much lower level of starting income).</p> <p>Drawdown pension arrangements allow funds to be managed so as to protect against inflation. Surviving spouses can continue to draw pensions, and, where there is no surviving spouse, residual funds can be paid to nominated beneficiaries subject to 55% tax, or tax free to charity where there are no surviving dependants.</p> <p>Those currently in unsecured and alternatively secured pension arrangements should check their next income review dates before 6 April 2011.</p> <p>Depending on a number of factors, the maximum withdrawal level may reduce for the under 75s. Those therefore drawing at or near the current maximum should prepare for a potentially lower income. It may be possible to request a review of the withdrawal level before 6 April 2011 to preserve the potentially higher maximum income available under the current rules until 2016.</p> <p>Those over age 75 are likely to have more flexibility in their income level from their next review date, and will be able to reduce income if appropriate to reduce tax and preserve the level of pension fund for nominated beneficiaries.</p> <p>Where we have not already done so, we will contact clients before 6 April 2011 to provide any recommended actions in light of the new rules.</p>	

Summary of Rules

Feature	Prior to 22 June 2010	Transitional Period	Proposed from 6 April 2011
1. Contributions⁽ⁱ⁾			
1.1. Annual allowance	£255,000	£255,000	£50,000
1.2. Limit for high earners ranking for marginal rate relief, without penalty⁽ⁱⁱ⁾	£20,000 to £30,000	£20,000 to £30,000	N/A
1.3. Rate of relief⁽ⁱⁱⁱ⁾	Up to 50%	Up to 50%	Up to 50%
1.4. Carry forward of unused contribution allowance	No	No	Yes ^(iv)
2. Lifetime allowance^(v)	£1.8 million ^(vi)	£1.8 million ^(vi)	£1.8 million reducing to £1.5 million ^(vi) from 6 April 2012
3. Tax free lump sum^(vi)	25% of fund, maximum of £450,000	25% of fund, maximum of £450,000	As left but reducing to a maximum of £375,000 from 6 April 2012
4. Pension income levels^(vii)			
4.1. Minimum rate under age 75	Nil	Nil	Nil
4.2. Minimum rate over age 75^(viii)	Male 5.3% Female 4.6%	As left if over 75 on 21 June 2010, otherwise nil	Nil
4.3. Maximum rate^(viii)		Age	Uncapped ^(ix) , or as below
		55 60 65 70 75	55 60 65 70 75
	Male	6.4% 7.1% 8.0% 9.4% 8.6%	5.3% 5.9% 6.7% 7.8% 9.5%
	Female	6.1% 6.6% 7.4% 8.4% 7.5%	5.1% 5.5% 6.2% 7.0% 8.3%
5. Death benefits^(x)			
5.1. Unvested fund before age 75	Tax free lump sum	Tax free lump sum	Tax free lump sum
5.2. Vested fund before or after age 75 (surviving spouse's or dependant's income withdrawals)	Withdrawals taxed as income	Withdrawals taxed as income	Withdrawals taxed as income
5.3. Vested fund before age 75 (paid as lump sum)	35% tax	35% tax	55% tax. Tax free if to charity ^(xi)
5.4. Vested fund after age 75 (paid as lump sum)	Tax free if to charity c82.5% tax if to others	As left if over age 75 on 21 June 2010 35% tax if under age 75 on 21 June 2010	55% tax Tax free if to charity ^(xi)

Notes

- (i) For defined benefit schemes, deemed contribution amounts will be 16 times any increase in accrued pension. Increases in deferred benefits because of inflation will be ignored.
- (ii) Regular (quarterly or more frequent) contributions of up to £245,000 per annum established before 22 April 2009 continue to qualify for marginal rate relief, without penalty, up to 5 April 2011, subject to the relevant pension input period maximum.
- (iii) There are certain circumstances where the effective rate of relief may be higher, for example for those with income of around £112,000 paying modest contributions.
- (iv) This applies for 3 years. For example, in 2011/12 a contribution of £200,000 may be made, less amounts paid in 2008/09, 2009/10 and 2010/11, with a maximum deduction of £50,000 for each of the earlier years, and the 2012/13 allowance may be paid in 2011/12 in addition, by manoeuvring pension input periods.
- (v) For defined benefit schemes, the valuation factor will remain at 20 times the annual pension, plus any lump sum.
- (vi) The existing protection rules will continue to apply for those who are subject to Primary and/or Enhanced Protection. There will be a new "Fixed Protection" which must be claimed by 5 April 2012, which will permit a lifetime allowance of £1.8 million, subject to no contributions being made or benefits accruing (except for inflation increases to deferred defined benefit schemes) after 5 April 2012. Fixed Protection will be suitable for those whose pension benefits exceed £1.5 million, or where growth is expected to increase their benefits up to the former £1.8 million limit. Where there is no protection, funds in excess of the lifetime allowance will be taxed at 25% if paid as income (in addition to marginal rate tax on the income), or 55% if paid as a lump sum, when pension benefits are taken, at age 75 or on earlier death.
- (vii) Rate examples are for unsecured / alternatively secured pension withdrawals, not annuity rates.
- (viii) These are not guaranteed and are based on current gilt yields, which fluctuate from month to month, and Government Actuary's Department factors, which may change.
- (ix) Uncapped withdrawals will be permitted for those with secure pensions (e.g. state pensions, or pension annuities) of at least £20,000 per annum.
- (x) All tax rates mentioned assume that benefits do not exceed the lifetime allowance or protected amount.
- (xi) Payment may be to charity if there are no surviving financial dependants.

This note is for general guidance only and represents our current understanding of law and HM Revenue and Customs practice as at 17 February 2011. 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 therefrom can go down as well as up and you may not get back the full amount you invested. Levels and bases of, and reliefs from, taxation are those currently applying or expected to apply, but are subject to change and their value depends on the individual circumstances of the investor. Saunderson House Limited is authorised and regulated by the Financial Services Authority.