

Client Briefing Note

As A-day approaches, it would appear that the legislation due to take effect from 6 April 2006 is far from complete. In Gordon Brown's pre-Budget Report on 5 December 2005, the advantages of holding residential property and chattels were all but completely removed in a very significant U-turn. In the same Report, there is also mention of a "small package of supplementary measures to ensure the pension tax rules operate as intended" which suggests that this may not be the final surprise. Thankfully, most of the legislation is now likely to last the course to A-day, carrying advantages for many.

THE MOST SENSIBLE U-TURN TO DATE?

The abolition of tax relief on pension funds used to purchase residential property (and certain other assets such as fine wines) is a major reversal on previous legislation but possibly a sensible thing. Although it is an unfortunate side effect that residential property bought for purely commercial reasons would no longer be attractive for pensions, the overall effect of this about-turn could well be to prevent a huge level of abuse harking back to the 70s. SIPP providers may have needlessly spent money in preparations for the new investment rules, but they may be saved millions by this tightening up of the legislation.

PROTECTING YOUR PROTECTIONS

For those clients with pension funds near to or exceeding the lifetime allowance at A-day (£1,500,000), the transitional protections afforded by the legislation, in particular enhanced protection, may be vital. By way of example, a 50 year old client with a pension fund of £1,500,000 at A-day who fails to elect for enhanced protection could face a tax charge of c£750,000 if they drew from their pensions at age 65 after achieving fund growth 5% per annum higher than the indexation of the lifetime allowance.

Electing for enhanced protection is not, however, the complete solution – the protection needs to be protected. The legislation is pitted with circumstances under which the protection will be lost, which require careful management. For example, the payment of a lump sum death benefit from a pension term assurance policy, a partial transfer of pension benefits from one scheme to another, contracting out of the state pension or the accidental payment of regular pension premium may all result in the irreversible loss of enhanced protection.

THE DEATH OF TAX-FREE PENSION DEATH BENEFITS?

In July this year, HM Revenue & Customs ("HMRC") published a consultation paper seeking responses on the detailed treatment of pension death benefits for inheritance tax purposes after A-day. What is clear from the consultation paper is that HMRC intends to apply an inheritance tax charge to funds in Alternatively Secured Pension ("ASP") on death after age 75. Surprisingly, however, the paper also appears to suggest individuals could be in danger of suffering an inheritance tax charge on unvested pension funds before age 75 if it is viewed that vesting is being deferred for estate planning reasons. The response to the consultation paper is eagerly awaited and an announcement from HMRC is expected in the New Year, when careful analysis and planning will be required.

KEEP IT IN THE FAMILY

Perhaps one of the most interesting aspects of the new legislation is the introduction of pension fund heritability after age 75. If an individual dies whilst in ASP, their residual fund can, after providing income for any dependants, be passed to a nominated member of the same scheme (e.g. a grandchild) in the form of vested or unvested funds. The received funds will not count against the receiving member's annual contribution allowance but will be added to any existing funds for the purposes of testing against their lifetime allowance at some point in the future. It is not yet defined what tax will be payable on the transfer, but it is likely to be a 40% inheritance tax charge. Nonetheless, this must be preferable to leaving it to an insurance company through an annuity.

Client Briefing Note**A-day Glossary****Annual allowance**

A limit on the maximum tax relieved annual contribution that can be made to a pension fund. From 6 April 2006, this will be £215,000 gross, indexed at quinquennially determined rates thereafter (it will be £255,000 gross from 6 April 2010) or net relevant earnings if lower subject to a minimum of £3,600 per annum. Tax relief will be granted at the contributor's marginal income tax rate. The annual allowance will not apply in the year that benefits are fully vested.

ASP – Alternatively Secured Pension

The new form of post-75 pension benefit which provides the long-awaited alternative to the annuity. Individuals can, under ASP, draw a flexible income from their pension fund after age 75 while leaving the fund invested in much the same way as in unsecured pension before age 75.

Enhanced protection

A transitional protection allowing individuals to avoid any future recovery tax charge, regardless of fund growth. This form of protection is dependent on the individual not making any pension contributions or accruing any defined pension benefit (above a certain defined rate of accrual) after A-day. An election for enhanced protection must be made before 6 April 2009.

Lifetime allowance

A limit on the value of an individual's pension fund, above which a recovery tax charge will be payable when death or vesting occurs. From 6 April 2006 this will be £1,500,000, indexed at quinquennially determined rates thereafter (it will be £1,800,000 from 6 April 2010).

Primary protection

A transitional protection allowing individuals with pension values in excess of £1,500,000 at A-day to establish their own personal lifetime allowance which will be indexed at the same rate as the statutory lifetime allowance and so allowing further pension contributions or accrual of further defined benefits. Fund growth at a greater rate than the indexation of the allowance will still result in a recovery tax charge being payable on vesting.

Recovery tax charge

A tax charge payable on the excess of an individual's pension funds over the lifetime allowance when benefits are crystallised (typically on vesting or death). The charge is 25%, except where the excess funds are paid as a lump sum, when it is 55%.

Secured pension

Defines a form of pension income after A-day with a guaranteed income for life. This will typically be an annuity.

Unsecured pension

The new term for income drawdown after A-day, available between age 55 and 75, allowing income to be drawn in a flexible manner while the pension fund remains invested.

Vesting

Taking benefits from one's pension funds. Describes the action of entering into a secured or unsecured income contract which may involve drawing tax-free cash and/or income. This will typically be the time when the recovery tax charge, if any, will apply.

Saunderson House would be pleased to provide advice to individuals in preparation for, and following, A-day. It is expected that demand for independent hourly rate fee based advice in the run up to A-day will be high. We therefore recommend you contact a Director at your earliest convenience to discuss what actions may need to be taken in preparation for the new legislation. Advice should be sought on all matters relating to A-day in the context of your overall financial position and future objectives.

This note is for general guidance only and represents our current understanding of law and HM Revenue & Customs practice as at 12 December 2005. 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 but are subject to change and their value depends on the individual circumstances of the investor. For income withdrawal 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 investment returns are poor and a high level of income is being taken – this could result in a lower income if and when an annuity is eventually purchased; annuity rates may be at a worse level when 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. Saunderson House Limited is authorised and regulated by the Financial Services Authority.