

# Pensions – the new tax regime

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## CONTENTS

Introduction	1
The core HMRC changes	1
Transitional provisions	10
Action points	13
The need for advice	16

## INTRODUCTION

One of the biggest changes ever made to the UK pensions system is set to take place from 6 April 2006 – designated A-Day by Her Majesty’s Revenue and Customs (HMRC). The process has been described as ‘simplification’ of the tax rules, and in many respects the description is accurate. But a number of aspects of the new regime are very complicated, in particular the transitional or changeover provisions as they apply to people with relatively substantial pension rights.

The main tax privileges that pensions have long enjoyed will broadly remain in place:

- Contributions into pensions by employers, employees and self-employed people will continue to qualify for full tax relief.
- The funds will be free of tax on capital gains and investment income, apart from the tax credit on UK dividends, which will stay non-reclaimable.
- The retirement benefits will remain available in part as a tax-free capital sum and in part as a taxable lifetime income.

The legislation is contained in the 2004 and 2005 Finance Acts and subsequent regulations. The regime is still subject to change and there will be more legislation in Finance Act 2006. However the main aspects of the new regime seem to be firmly established.

Anyone accruing pension benefits – and even a number of those already drawing them – should look at their position in the light of these major changes. It is important to get competent professional advice before 6 April 2006. There are certain decisions and actions that need to be made in advance of A-Day.

## THE CORE HMRC CHANGES

The key to HMRC’s approach is the introduction of a single new pension tax regime to replace all the existing approved regimes, including retirement annuities and unapproved pension schemes. Although there will be many

transitional arrangements, the existing pension regimes will disappear. HMRC says that the result will be to reduce eight sets of pension rules to just one.

For the vast majority of pension scheme members, the changes will make pensions much simpler and easier to understand. A small minority, estimated initially at about 10,000, will be affected by the new lifetime allowance.

Probably the easiest way to understand the new structure is to examine its key components and then consider the transitional arrangements that will apply.

### **What is the lifetime allowance?**

In place of the existing earnings cap (£105,600 in 2005/06), you will be entitled to accumulate a maximum total amount of £1.5 million in tax-favoured pension funds. HMRC claims that the £1.5 million is broadly equal to the cost of providing maximum occupational scheme benefits for a 60 year old with earnings equal to the earnings cap. However, this is only on the basis adopted by HMRC, which has chosen a 20:1 factor for converting post A-Day scheme pensions to cash (£1.5 million = £75,000 x 20). If you were to buy the corresponding £75,000 lifetime annuity from an insurance company, you could expect to pay around £2.2 million at current rates.

If you are in a defined contribution (DC) pension arrangement, the lifetime allowance will simply apply to your total pension fund in most cases. If you are in a defined benefit (DB) scheme, for the purpose of checking against the limits, your final pension will be converted to a fund using the 20:1 conversion factor.

The lifetime allowance will rise in stages to £1.8m in 2010/11. After that, increases will be determined by the Treasury, probably for five yearly periods. The fact that in the early years the allowance will increase at a rate faster than expected inflation will initially limit the increase in the number of people affected by it.

### **How will the lifetime allowance charge apply?**

If you have a fund of more than the lifetime allowance when you take your benefits, the excess will be subject to a 'lifetime allowance charge'. If you take the excess as cash, the charge will be 55%.

The lifetime allowance charge is reduced to 25% if you use the excess to provide additional retirement income. However, since this income would itself be subject to income tax (probably at 40%), the likely overall effective tax rate would remain at 55%, ie (100% - 25%) of the lifetime allowance charge x 40% + 25%.

### Example 1: Exceeding the lifetime allowance

Graham reaches retirement with total pension funds worth £2.5m. At the time, the lifetime allowance has risen with inflation to £2m. Assuming that Graham does not qualify for any transitional reliefs, he has two ways of dealing with the £500,000 excess:

- He can draw £225,000 as cash, with the balance of £275,000 representing the lifetime allowance charge.
- He can use £375,000 to buy an annuity or start income drawdown. The balance of £125,000 is taken as the lifetime allowance charge and the income Graham receives will also be taxed.

The lifetime allowance charge makes overfunding pensions a tax-inefficient option. However, it could be difficult to avoid overfunding. For example, if your pension fund were to grow rapidly in the last year before you drew benefits, you could find that HMRC might take 55% of much of the growth.

### What is the annual allowance and how will it apply?

Your pension arrangements will be subject to a total annual tax-efficient contribution limit of £215,000 in addition to the lifetime allowance. This contribution ceiling will rise by £10,000 a year to £255,000 by 2010/11. Thereafter, increases will be determined by the Treasury, like the lifetime allowance.

The £215,000 annual allowance is the combined amount that you and any employer can contribute to your pension during a year without a tax penalty. As an employee or self-employed person, you can contribute the greater of £3,600 or 100% of your earnings, with tax relief. Your employer can make up the balance to £215,000 and will gain automatic tax relief, subject to the normal Taxes Act rules on allowable expenditure.

**For active members of final salary (defined benefit) pension schemes** the contribution will be calculated as the increase in value of the employees' pension benefits during the course of the year. HMRC will value accruing benefits on a 10:1 basis in place of the 20:1 ratio used at retirement.

**For deferred members of final salary schemes** – ie those who have benefits in a scheme that they have left – it is only the increase over and above inflation-proofing (or 5%, if greater) that counts as a 'contribution' for these purposes, although HMRC may specify an additional limit in regulations. So deferred scheme members will not be caught by the annual allowance, unless their prospective pension benefits (after inflation adjustment) increase by more than £21,500 in 2006/07 ( $£21,500 \times 10 = £215,000$ ).

**For members of money purchase pension arrangements** (including personal and stakeholder pensions), only the contributions made by the employer or employee in the scheme year will count. Any investment growth (or loss) in the value of the fund will be ignored, as will any National Insurance Contribution contracting out rebates.

If the total contributions to your pension exceed the annual allowance, you will be subject to an annual allowance charge of 40% under self-assessment on any excess contribution. The contributions will remain within the pension arrangement, and you could therefore face a further tax charge when they come to be used to provide benefits. Exceeding the annual allowance is therefore tax-inefficient and best avoided. There is one occasion when the annual allowance will not apply to contributions to a scheme. That will be any year when you take benefits in full from that pension scheme. This relaxation prevents the limit from biting if the value of your benefits were to jump because you retired early on favourable terms or took early retirement because of ill-health.

In practice, the annual allowance will be much more generous than the current contribution limits for all but the highest earning members of occupational pension schemes. For example, the maximum annual contribution to a personal pension (if you were born before 7 April 1944) is currently £42,240 (ie 40% of the £105,600 earnings cap).

### Example 2: Exceeding the annual allowance

Norma, aged 55, is a member of her employer's non-contributory final salary pension scheme. In 2007/08 she is promoted to the main board and her salary rises by £45,000. Her prospective pension increases correspondingly by £25,500 a year because she has been a member of her employer's scheme for 35 years. The annual allowance during the year is £225,000.

The deemed value of the contribution during the year is:

$$£25,500 \times 10 = £255,000.$$

Norma therefore has to pay 40% tax on the £30,000 (£255,000 – £225,000).

**Planning note** *It would be possible to avoid the annual allowance charge by making about £5,300 of Norma's pay increase non-pensionable for its first year of payment. This would limit her pension increase to £22,500. In the following year, 2008/09, the extra salary could become pensionable without causing any tax charge, unless Norma had another substantial salary increase.*

### What will be the rules for a person's retirement age?

The concept of a normal retirement age will disappear under the tax rules, as will the current constraints on employees drawing occupational benefits while they still remain employed. However, from 6 April 2010, there will be an increase in the minimum age at which you can draw benefits from 50 to 55.

### How large can the tax-free cash sum be?

The general limit for tax-free cash when benefits are drawn will simply be 25% of the value of your total benefits for any pension arrangement. This will include Protected Rights, ie funds built up from contracting out of the State Earnings Related Pension Scheme (SERPS) and/or the State Second Pension (S2P) via a personal pension or money purchase occupational scheme.

Additional voluntary contributions (AVCs) and free-standing AVCs will provide tax-free cash directly, which is not normally permitted under the current rules.

There will be no cash ceiling on the amount of tax-free cash, other than the initial £375,000 stemming from the maximum 25% of the £1.5m lifetime limit.

#### Example 3: Tax-free cash

Altaf reaches retirement at age 60 with an occupational scheme fund worth £200,000, a retirement annuity worth £40,000 and personal pensions worth £60,000. Assuming that Altaf does not qualify for any transitional reliefs, the maximum tax-free cash he can draw from each is:

Occupational scheme:	£200,000 @ 25% =	£50,000
Retirement annuity:	£ 40,000 @ 25% =	£10,000
Personal pension:	£ 60,000 @ 25% =	<u>£15,000</u>
<b>Total</b>		<b><u>£75,000</u></b>

Under the existing regime, there would be three different calculation bases, although the personal pension maximum would be 25% of fund.

If you have joined an occupational pension scheme since 17 March 1987, you should gain from the 25% of fund proposal, unless the total contributions made to the scheme are relatively low. In contrast, under the current rules, the tax-free lump sum will be the equivalent of only 15%-20% of the accumulated fund for a member of a typical final salary scheme, building up a pension at a rate of 1/60<sup>th</sup> for each year of service, according to one estimate. Similarly, in virtually every case, there will be an increase in the maximum cash you could draw from a retirement annuity (the predecessors of personal pensions). However, pension schemes and providers will not be obliged to pay the new maximum tax-free cash sums, and it is possible that some will retain their old basis within their specific scheme rules, provided it does not breach the new 25% limit.

The downside of the change is that it will mark an end to the scope for occupational schemes to fund mainly or solely for cash. In addition, many of the defined contribution schemes recently established to replace final salary arrangements will pay out less cash, because their average employer contribution levels are only about 6%. At such modest contribution levels, the current tax rules can allow more than 25% of the fund to be drawn as cash.

### What will be the death-in-service benefits?

The maximum death benefit payable before retirement benefits are drawn will be a lump sum equal to the lifetime allowance. All the complex salary-related constraints that currently apply to occupational schemes will disappear. If the total amount of life assurance and other benefits available exceeds the lifetime limit when a person dies:

- Any excess paid as a lump sum will be subject to the 55% lifetime allowance charge, payable by those who receive the benefits.
- But any excess used to provide dependants' benefits (eg annuities) will not be subject to a lifetime allowance charge.

#### Example 4: Death-in-service benefits

On Kate's death in January 2011, her pension plans and pension life cover are valued in total at £2.2m. By that time the lifetime allowance has increased to £1.8m. Assuming that Kate did not qualify for any transitional reliefs, the pension plans can provide:

- A lump sum of £2.2m, on which there would be a lifetime allowance charge of £220,000 (£400,000 @ 55%); or
- Dependants' pensions with a value of £2.2m; or
- A lump sum of £1.8m *plus*
- Dependants' pensions with a value of £400,000 (and no lifetime allowance charge).

In theory, survivors' pensions can be provided instead of any lump sum under the lifetime allowance, but it is hard to see why this option would be chosen below the lifetime allowance unless dependants' pensions had to be paid, eg under contracting-out rules or scheme rules. A tax-free lump sum will provide more flexibility and, if income were required, the capital could be used to buy a purchased life annuity, which has tax advantages over its pension counterpart.

At present, many occupational schemes, particularly final salary schemes, offer dependants' pensions and a lump sum on death-in-service. Under the new regime, such schemes will be under pressure to pay only a (larger) lump sum.

### How can income be drawn from pension schemes?

There will be four different methods of drawing income from your pension arrangements:

1. *Scheme pension payments* are pension payments made directly by pension schemes. Death benefits after retirement can take the form of either traditional guarantee periods of up to ten years or 'pension protection' (also called capital protection). Under pension protection, the maximum lump sum payment on death before age 75 would be the *original* pension value, less gross income payments made, less a 35% tax charge. Alternatively, final salary pension schemes will be able to offer a tax-free lump sum as if the pensioner were still an employee. Lump sum payments will not normally be permitted on death after age 75. Defined benefit schemes are only allowed to make scheme pension payments.
2. *Lifetime annuity payments* are pension payments in respect of money purchase schemes made by authorised insurance companies. These are subject to the same type of death benefit options as scheme pension payments.

#### Example 5: Annuity protection on death

Five months after his 65<sup>th</sup> birthday, Simon uses his £150,000 pension fund to buy an annuity with annuity protection, providing him with a gross income of £10,000, payable yearly in arrears. At age 74<sup>1/2</sup>, Simon dies one month after receiving his ninth income payment. Under annuity protection, the lump sum payment will be:

Purchase price of annuity	£150,000
Less Total gross income received	<u>(£ 90,000)</u>
Gross lump sum death benefit	£ 60,000
Less Tax at 35%	<u>(£ 21,000)</u>
<b>Net lump sum</b>	<b><u>£ 39,000</u></b>

*If Simon died after reaching age 75, but before the next annuity payment was due, there would be no lump sum payment.*

3. *Unsecured pension* is only available from money purchase schemes, and includes withdrawals directly from a pension fund. The maximum annual income under the unsecured option that can be drawn from your accumulated fund is 120% of the highest level of income that could be drawn from the fund based on the Government Actuary's Department (GAD) annuity tables. To judge by draft tables issued in November 2005, the new maximum will be similar to the limit that currently applies under existing income withdrawal rules. There is no minimum withdrawal set by HMRC – so you need not take any income – but a minimum may be imposed by the Department for Work and Pensions.

- By age 75, you will either have to buy a lifetime annuity or switch to an alternatively secured pension (see below).
  - As an alternative to fund withdrawals, part of the fund could be used to buy a fixed annuity for a maximum term of five years (but not beyond age 75). The maximum income would be the same 120% of the GAD annuity amount.
  - Death benefits before age 75 would be the same as apply to pension fund withdrawals now, ie a return of the remaining fund on death, subject to a 35% tax charge. Alternatively, the whole fund could be used to provide dependants with pensions or continued withdrawals. In a consultation paper published in July 2005, HMRC suggested that death benefits will normally be subject to inheritance tax, which is not the case under the current regime.
4. *Alternatively secured pension (ASP)* will be a new option which is only available from money purchase arrangements. This will be a restricted form of pension fund withdrawal only available from age 75. ASP was originally proposed to meet the needs of certain religious groups that have ethical objections to annuities, but in practice it is likely to become regarded as a restricted means of extending income drawdown beyond age 75. The maximum ASP withdrawal will be only 70% of the GAD annuity tables figure and reviews will be annual, but based on GAD rates for age 75. At current interest rates the maximum withdrawal will be around 6.9% for men and 6.1% for women.

Funds remaining on death must in the first instance provide pensions for dependants. If there are no dependants, then the funds may be transferred to a nominated charity or pass to another nominated member of the pension scheme. The precise inheritance tax treatment of such transfers is still not clear, although HMRC said in its July consultation paper that normally there will be a tax charge. Further details are awaited.

### **What will be the restrictions on pension scheme investments?**

Under the Finance Act 2004 legislation, the new regime was to have removed most of the current restrictions on pension scheme investment. However, in the December 2005 Pre-Budget Report, the government announced that the Finance Bill 2006 would contain legislation to impose tax penalties on pension scheme investment in residential property and certain other assets such as fine wines, classic cars and art and antiques. As a result, the new investment rules – which will apply across all schemes – will be similar to today's rules.

The special rules for small self-administered schemes (SSAs) and self-invested personal pensions (SIPPs) will disappear, including the requirement for SSAs to have a pensioner trustee.

There will also be a tightening of the rules in some areas:

- The total holding of shares by a pension fund in a single sponsoring employer must not be 5% or more of fund value, compared to the current 50%.
- Loans to employers, other than in the form of bonds issued on the open market, will have to:
  - Not exceed 50% of the net value of the fund at the date the loan was granted.
  - Be secured as a first charge on assets that must initially have a value at least equal to the loan.
  - Charge a minimum interest rate currently set out in draft regulations as 1% over the average base rate of the six main clearing banks, rounded up to the higher 0.25%.
  - Normally last for no more than five years, during which time they will be repaid by equal annual instalments. However, it will be possible to roll over loans for a further five-year period if the employer is having difficulties in meeting payments due.
- Loans to a pension scheme will be limited to 50% of the net scheme assets, eg a fund with net assets of £200,000 may borrow £100,000.

Commercial property will remain an eligible scheme investment, even though the option to invest in residential property has been withdrawn.

### **How will unapproved schemes be taxed?**

Unapproved schemes (which will be renamed 'employer-financed retirement benefit schemes') will not receive any tax privileges under the new regime. For funded unapproved retirement benefit schemes (FURBS) this will mean:

- You will not be taxable or subject to NICs on employer contributions.
- Your employer will not receive any tax relief for their contributions until you have started to receive benefits.
- Investment income and capital gains within the fund will be liable at a rate of 40% (32.5% for dividends). Capital gains have been taxable at 40% since 6 April 2004 under general trust taxation reforms.
- All benefits will be liable to income tax, but will normally be NIC-free.
- Death benefits will be potentially subject to IHT.

If you are a member of an unfunded unapproved retirement benefit scheme (UURBS), the situation will be as now. Your employer will receive tax relief on benefit payments and you will pay income tax on them.

Unless any transitional reliefs are used, neither UURBS nor FURBS will count towards the lifetime or annual allowances, nor will they be subject to any lifetime allowance charge.

### TRANSITIONAL PROVISIONS

Not all vestiges of the old regimes will disappear immediately on 6 April 2006 (A-Day). There is a raft of transitional arrangements that will apply to people's rights and benefits acquired before A-Day. These include:

#### What happens if the lifetime allowance is exceeded?

If the value of your benefits and rights on A-Day turns out to exceed the lifetime allowance, you will have three years from A-Day in which to register them with HMRC, although in practice a decision needs to be made by A-Day. Such rights can be protected in two ways:

- *Primary protection* The value of your A-Day rights will be revalued in line with the rise in the lifetime allowance. Any excess over this amount at the time of drawing your benefits will suffer a lifetime allowance charge.
- *Enhanced protection* Normally you will have to cease active membership of all your pension arrangements before A-Day. All benefits (calculated on the pre A-Day basis) will then be free from a lifetime allowance charge. If you choose this option and also elect for primary protection, then by making a pension contribution, however small, you can switch to primary protection at any time after A-Day and before your 75<sup>th</sup> birthday.

Enhanced protection will also be available if your A-Day fund is less than the lifetime allowance. In practice, it may be hard to see why anyone would initially choose primary protection, but remember that enhanced protection is only an option if you accrue no further benefits from your pension arrangements before A-Day. For money purchase arrangements, this means no further contributions. For final salary schemes it usually means no further pensionable service, although because some increases in respect of salary/price inflation are permitted under the transitional rules, if your earnings grow slowly you may be able to continue in service.

#### Example 6: Primary protection and enhanced protection

On 5 April 2006, Julia is a member of a SSAS with a fund of £1.8m. She registers this with HMRC and contributions to the scheme cease. Nine years later, when her fund is worth £3m, she decides to draw her retirement benefits. The standard lifetime allowance at that time has risen by 50% to £2.25m.

- *If she has chosen primary protection*, she is allowed to draw benefits up to a value of £2.7m (£1.8m x 150%) without any lifetime allowance charge. The balance of £0.3m is subject to a lifetime allowance charge before any benefits are taken.
- *But if she has chosen enhanced protection*, she is allowed to use all £3m to provide benefits without any lifetime allowance charge.

### Who will be able to retire early?

The minimum retirement age will rise to 55 in April 2010. However, you will still have the right to earlier retirement if:

- You are an occupational scheme member who has a *contractual* right to retire before age 55 that was in existence before 10 December 2003.
- You are a member of statutory schemes (eg civil servant) and were given a contractual right to retire before 55 at any time before 6 April 2006.
- You joined an occupational pension scheme between 10 December 2003 and 5 April 2006, and it was normal practice before 10 December 2003 for employees in the scheme to be able to retire before 55.
- You are a member of a personal pension scheme or retirement annuity with a low retirement age (eg sportsperson). However, early retirement will only apply in respect of existing benefits, and will be subject to certain conditions, including a proportionate reduction in the amount of lifetime allowance available.

For occupational schemes, before 6 April 2006 a right to retirement before age 55 is protected if there is a corporate restructuring, a scheme is wound up and benefits transferred to a new pension arrangement or a block transfer (affecting at least two members) takes place.

There is no transitional relief for ordinary investors in personal pensions (including stakeholder pensions), which currently permit retirement from age 50 onwards.

### What happens if the tax-free cash sum exceeds the new limits?

The transitional reliefs for the tax-free cash sum are among the most complicated.

Assume that on A-Day you had accrued a tax-free lump sum benefit of more than 25% of the value of your benefits. If your tax-free cash entitlement at A-Day is not more than £375,000 and you have not elected enhanced or primary protection, at the time when you draw your benefits the pension scheme will be able to provide you with:

- The lump sum accrued *before A-Day* increased in line with the increase in the standard lifetime allowance,
- *Plus* 25% of the fund deemed to have accrued *after A-Day* where additional contributions have been paid to a pre A-Day arrangement. The deemed amount is calculated as the total fund when benefits are drawn, less the A-Day fund increased in line with the lifetime allowance. This situation will only apply to occupational schemes and buy-out (s32) policies (which cannot presently accept further contributions). Other pension arrangements,

with the exception of a limited number of retirement annuities, cannot currently provide more than 25% of the fund. If returns are low, then the deemed amount may be nil.

### Example 7: Protecting tax-free cash – more than 25% of fund

On A-Day, Jeremy has an executive pension plan with a fund of £300,000, of which his lump sum cash entitlement is £100,000. He retires in June 2010, by which time the lifetime limit has risen by 20% and his total fund is £500,000, thanks to additional contributions. Jeremy's tax-free cash would be calculated as:

Pre A-Day rights: £100,000 x 120%	= £120,000
Post A-Day rights: (£500,000 – [£300,000 x 120%]) @ 25%	= <u>£ 35,000</u>
<b>Total tax-free cash</b>	= <b><u>£155,000</u></b>

Where you have opted for protection and your tax-free cash entitlement at A-Day exceeds £375,000, then tax-free cash would also be protected. The method used will depend on which form of lifetime limit protection you choose. As a general rule the result will be:

- *Primary protection* The pre A-Day lump sum will be adjusted in line with the increase in the lifetime allowance.
- *Enhanced protection* The maximum lump sum will be the same percentage of the capital value of your pension rights at retirement as it was at A-Day.

### Example 8: Protecting tax-free cash – more than 25% of lifetime limit

On A-Day, Arabella has an executive pension plan with a fund of £1.6m, on which her lump sum cash entitlement is £480,000 (ie 30%). She retires seven years later, when the plan's fund has grown to £2.4m and the standard lifetime allowance has risen by 27%. Arabella's tax-free cash is calculated as:

- *If she had chosen primary protection:*  
 $£480,000 \times 127\% = £609,600$
- *If she had chosen enhanced protection:*  
 $£2,400,000 \times 30\% = £720,000$

### Investment

Pre A-Day investments in SSAs and SIPPs will be subject to transitional protection. This will mean that they could remain, even if they were outside the rules of the new regime. However, if there were to be a change after A-Day in the terms of a loan made by a scheme before A-Day, the whole loan will become subject to the new rules.

### Unapproved schemes

If you are a member of a FURBS and have been taxed on your employer's contributions, then the lump sum benefit accrued before A-Day will be protected. The lump sum available at A-Day is increased in line with the RPI to the date that benefits are drawn. The IHT benefits will also be protected in respect of pre A-Day funds. However, 40% tax on investment income (32.5% on dividends) will apply from 2006/07.

UURBS can be consolidated into a registered (formerly approved) pension scheme within three months of A-Day, without the value transferred counting towards the £215,000 annual allowance (although it will ultimately count against the lifetime allowance).

## ACTION POINTS

Many pension planning points need to be reviewed before April 2006. For example:

### Retirement date before A-Day

If you are due to retire before the new rules begin, it could pay you to defer your retirement. If you wait until after A-Day:

- The tax-free cash from your main scheme could turn out to be higher under the new 25% of fund basis, if you are a member of an occupational scheme. You might also be able to draw tax-free cash from AVCs and FSAVCs.
- You might be able to enjoy more flexible benefits under the new rules. For example, the unsecured pension route will allow you to take all your tax-free cash entitlement without having to draw any income.
- If you decide to buy an annuity with your pension fund, you will be able to opt for annuity protection.
- If you are a member of a final salary scheme, you may be able to receive higher post-retirement lump sum death benefits.
- You will avoid HMRC valuing any pension that you have started to receive before A-Day more highly than if you wait. The higher valuation is intended to take account of tax-free cash – even if it was not available. It also greatly overstates the true value of your pension if it is not inflation-linked in any way or you are taking drawdown from your fund. In the case of drawdown, HMRC multiply by 25 the maximum income you can take each year, not the amount you are actually drawing.

One difficulty is that many pension schemes are unlikely to allow their members to take advantage of all of the options permitted by HMRC's reform. For example, in some money purchase arrangements an unsecured pension might not be available and final salary occupational schemes might not be prepared to offer 25% tax-free cash from 6 April 2006.

### **Retirement after A-Day – funds under lifetime allowance**

If you are due to retire after the new rules come into force, some of the areas that you need to consider are:

- *Is investment within pension plans the right retirement planning strategy for you now?*

The annual allowance makes it possible to delay the start of pension contributions until much nearer retirement than is currently possible. This will be especially the case as there will be no annual allowance ceiling for a scheme in the final year before drawing pension benefits in full from that scheme.

Some experts have suggested that the right strategy now will be to use other savings vehicles initially – such as individual savings accounts (ISAs) – and then apply their value as fund contributions when retirement nears. This will provide greater flexibility because the funds would not be locked in a pension plan until a later date. However, outside an ISA, the strategy might be less tax-efficient and runs the risk that future changes in legislation or personal circumstances could limit the scope for last minute contributions.

- *How should you top up the retirement benefits from your employer's pension scheme?*

After A-Day, it will make no difference how you decide to top up your retirement benefits, because the same tax rules would apply to all pension arrangements. However, in practice not all top up arrangements are likely to offer the full flexibility that the new rules should make possible. For example, in-house AVCs would be unlikely to offer an unsecured pension option or a wide range of investment options.

- *Should you change your pension investment strategy?*

The more relaxed investment rules will allow you to change the investment structure of your fund, for example, by the fund borrowing to invest in commercial property. In contrast, you might prefer to sacrifice potential investment growth in return for lower risk if your pension fund were close to the lifetime allowance, in order to avoid the lifetime allowance charge.

- *If your fund is close to the lifetime allowance, should you opt for enhanced protection?*

Enhanced protection would mean that if your fund grew to over the lifetime allowance, you would not suffer any lifetime allowance charge. However, it would also normally mean that you would have to cease active membership

of all schemes, although you can revoke the enhanced protection option at any time before age 75.

- *Do you need to fill an income gap before age 55?*

If you want to retire before age 55, but this would be after 5 April 2010, you could not look to your pension arrangements to provide you with an immediate replacement income without transitional protection. You might therefore need another retirement investment to bridge the gap before you could draw on your pension plans.

- *How should you draw retirement benefits?*

Just because you will be able to draw 25% of your fund as a tax-free lump sum will not mean that you should automatically do so. At present, the factors used by many final salary schemes to convert pension to cash fail to reflect the pension's true value. Strange though it may seem, a taxed pension can sometimes be better value than a tax-free lump sum.

### Retirement after A-Day – funds over lifetime allowance

There are some difficult choices to be made if the total value of your pension funds at A-Day is over the lifetime allowance.

- *Should you or your employer make further contributions before A-Day?*

The immediate answer to this appears to be yes, provided your pension scheme will not be overfunded as a result. However, on closer examination you will need to take care, because the extra contributions can end up just buying extra taxable pension or a taxable lump sum, because of the way the transitional relief operates.

- *What transitional protection should you opt for?*

Within three years of A-Day you must register your funds with HMRC and opt for primary protection and/or enhanced protection. Enhanced protection will be the obvious first choice. It will protect all your funds from a lifetime allowance charge and still leave you the option to apply primary protection later (provided you elected for both options), if you wanted contributions to be resumed, for example because of a fall in fund values when you near retirement.

- *What should you do about any funded unapproved schemes (FURBS)?*

The tax rate on income within FURBS will rise from 6 April 2006 (the rate of tax on gains has already increased) so you should review the plan's investment approach. It could make sense either to withdraw funds and invest them personally or restructure the FURBS investment holdings.

- *How should you and/or your employer fund for your retirement?*

Employer contributions to FURBS after A-Day will be less attractive than they are currently, because the employer will not benefit from immediate tax relief and then all the benefits will be taxable as income. You and your employer will need to consider alternative remuneration strategies, for

example share incentive schemes or simply increased pay that can fund tax-efficient personal investment, eg via venture capital trusts (although the 40% tax relief now available is coincidentally due to disappear on A-Day).

### Employer considerations

If you are an employer and have pension arrangements for your employees, the pension tax reforms could have a major impact on this aspect of your remuneration structure.

- *How should you deal with those affected by the lifetime allowance?*  
Some of your most senior, and longest serving, employees could find that it makes no sense for further pension contributions to be made on their behalf after A-Day. This will raise complicated issues of redesigning remuneration strategy, because shorter serving but equally senior employees may not be immediately affected by the lifetime allowance.
- *What should happen to existing pension arrangements?*  
The new tax rules will raise awkward questions about how many changes should – or must – be made in the light of the tax reforms. In some instances, the reforms might prompt a total review of retirement provision. The sooner you start to think about the impact of the reforms, the better.
- *How should you communicate the changes to employees?*  
Many employees will be largely unaffected by the reforms, particularly those who are members of group personal pension or stakeholder arrangements. Others will be winners because they will be able to draw more tax-free cash. Some will be losers, because their prospective tax-free cash will be reduced. The message of the changes needs to be communicated clearly and early, because employees close to retirement might find they want to change their retirement date.

### THE NEED FOR ADVICE

At the time of writing, the reforms described above are set out in the Finance Act 2004, Finance Act 2005 and various draft and final regulations. Parts of the structure, such as the final investment rules, are still to be detailed in the Finance Act 2006 and all the regulations may not be identical to current drafts. This possibility and the complexities of transition from eight pension regimes to one mean that you should get advice before taking any action. The timescales involved are tight, so initial advice is best obtained as soon as possible.

This guide is for general information only and is not intended to be advice to any specific person. You are recommended to seek competent professional advice before taking or refraining from taking action on the basis of the contents of this publication. The guide represents our understanding of the law and HM Revenue & Customs practice as at December 2005, which are subject to change.

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