Pensions Update – Tax Simplification – the Basics

Welcome to the first in a series of updates on tax simplification that Osborne Clarke will be sending to you over the course of the next few months, prior to ‘A-Day’ on 6 April 2006. The aim of these updates is to give you the background to tax simplification, and to highlight the main issues that trustees, pension schemes and sponsoring employers are facing as a result of this radical shake up in the pensions landscape.

In this first update, we cover the basics of tax simplification: the history and purpose behind the government's decision to do this, what is being swept away, and key concepts under the new regime.

History

The government's first consultation document on this issue, "Simplifying the taxation of pensions: increasing choice and flexibility for all" was published in December 2002. The foreword stated that "the complexity of the current tax rules have made pensions hard to understand even for experts". The government therefore decided to put forward radical proposals to sweep away the existing eight different sets of tax rules in use for pensions, with the intention of assisting people to "make clear and confident decisions about pension saving".

A second consultation document, "Simplifying the taxation of pensions: the Government's proposals" was published in December 2003. Many of the proposals in the first paper reappeared in the second, with some amendments and additions.

The final proposals were set out in the Finance Act 2004, with alterations made by the Finance Act 2005.

The changes will come into force on 6 April 2006, a date commonly referred to as 'A-Day'.

Key concepts

There will no longer be limits on the amount of pension savings an individual can build up in a registered pension scheme. However, some controls will still be imposed, crucially through two mechanisms: a lifetime allowance and an annual allowance.

Lifetime allowance (LTA)

The value of a member's benefits from all registered pension schemes will have to be tested against the LTA when a 'benefit crystallisation event' occurs – this could be, amongst other things, retirement, death before retirement, or transfer to an overseas pension scheme. Where the value of the member's benefits exceeds the LTA, a fixed-rate tax charge will apply to the excess. The LTA will be £1.5 million as of A-Day, rising to £1.8 million by 2010/11. The rate of increase thereafter has not been specified. The logic behind the choice of the figure of £1.5m is as follows:

- The current earnings cap is approximately £100,000 (£105,600 for 2005/06);
- A 2/3rds pension would therefore be almost £75,000;
- An increasing annuity with 2/3rds spouse's pension would cost about £20 per £1 of annuity;
- £75,000 multiplied by 20 = £1.5m.
This is one of the most controversial areas of the Government's proposals, because the level of the LTA is considered by many to be too low with the result that too many modest income earners may be caught by it.

Based on the following assumptions, the Government believes it has got the level of the allowance right:

- the £1.5 million LTA is, using a factor of 20:1 to calculate the capital value of a defined benefit pension, equivalent to the maximum pension available under the current occupational pension regime which includes the earnings cap;
- only about 5,000 people (pre-87 and pre 87-89 members) will have pension funds worth more than £1.5m by 5 April 2005 (A-Day minus 1), and
- over the next 10 years, only about 1,000 more people per year may come up against the new limit.

Annual allowance

Although members will be able to make unlimited contributions, they will only receive tax relief on contributions each year up to £3,600 or 100% of UK earnings, capped at the level of the annual allowance, which is set at £215,000 from A-Day, rising to £255,000 by 2010/11 with unspecified reviews thereafter. The annual allowance cap will also apply to the increase in the capital value of benefits accrued in a final salary scheme.

Certain payments will not contribute towards the annual allowance:

- personal contributions in excess of 100% of earnings (or £3,600, if higher) because they will not qualify for tax relief;
- age-related NIC rebates to contracted-out money purchase schemes or appropriate personal pension schemes;
- transfers-in from registered pension schemes and recognised overseas schemes.

Note that contributions to money purchase schemes, and benefit growth in final salary schemes, will be exempt from the annual allowance in the year in which the benefit is taken in full. This addresses concerns raised during consultation that the annual allowance could trigger a charge on redundancy or early retirement (particularly in circumstances of ill-health).

Lifetime allowance charge

This charge will be levied on benefits in excess of the LTA. A tax charge of 25% will be made on funds in excess of the LTA if used to provide a pension, or if excess funds are taken as a lump sum they will be subject to a tax charge of 55%.

Valuation factors

When a benefit crystallisation event occurs, and benefits are tested against the LTA, this involves a valuation of the benefit and depends on the style in which the benefit is taken.

<table>
<thead>
<tr>
<th>Style of pension (benefit)</th>
<th>Value for LTA test</th>
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<tbody>
<tr>
<td>Tax-free lump sum</td>
<td>Value of lump sum</td>
</tr>
<tr>
<td>Pension in payment</td>
<td>x 25</td>
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<tr>
<td>Scheme pension (direct or by annuity selected by the trustees)</td>
<td>x 20</td>
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<tr>
<td>Lifetime Annuity (annuity selected by the member, DC or PP)</td>
<td>Purchase price of annuity purchased for the member</td>
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<tr>
<td>Unsecured Income (e.g. drawdown)</td>
<td>Market value of assets</td>
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In order to value the capital worth of defined benefits for the purpose of the LTA, there will be a single valuation factor of 20:1, a figure suggested by the Association of Consulting Actuaries. The factor of 20 will apply when a pension starts to be paid regardless of the member's age. The introduction of a single factor has largely been welcomed for the clarity and administrative simplicity it brings.

Individuals who receive payment of a pension at 5 April 2006 will be treated as having used up part of their LTA if, after 5 April 2006, they receive payment of a new benefit. The factor for valuing such pensions will be 25:1, which reflects the fact that people will generally have taken tax-free lump sums.

A valuation factor of 10:1 will be used to measure the increase in the capital value of benefits accrued in a final salary scheme for the purpose of the annual allowance.

Future updates

In our next update on tax simplification we will look at transitional arrangements which allow members to protect benefits they have accrued prior to A-Day. Over the course of the next few months we will issue further updates covering the other key areas in tax simplification.

For more information or advice on any of the topics covered in this publication, please contact your usual Osborne Clarke contact or:

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