PENSION SIMPLIFICATION OR IS IT?

Probably the most radical overhaul of pensions legislation ever comes into effect on the 6th April 2006 ('A Day'). Whilst we still await full and final details, we know enough now to produce our first newsletter on the subject.

The Government's intention was to simplify what is over-complex legislation and increase consumer confidence in pension planning. For clients new to pensions after April 2006, this objective will largely be achieved and the advice process will be a lot less complex than it is now. Currently we have to grapple with several sets of rules governing different types of pension schemes and they are all going to be harmonised into one set of rules applicable to all types of schemes. However, the legacy of existing pension plans and their interaction with the new legislation will require detailed and careful consideration on a client by client basis

Contributions

Personal contributions, whether from the employed or self-employed, will be limited to 100% of earnings each year (or £3,600 if greater) subject to an overall limit of £215,000. This limit will rise to £255,000 by 2010. The position after that is unclear.

Employers can contribute unlimited amounts but any contribution in excess of £215,000 in aggregate will be taxed on the employee as a benefit in kind.

One welcome exception to this rule is in the year of retirement, when contributions are unlimited, although employer contributions in excess of £500,000 will be "spread" over up to four years for Corporation Tax relief purposes.

If you are planning, or hoping, to buy a commercial property with your SSAS or SIPP, it may be a good idea to have done so by the 6th April 2006. From that date, the amount your pension scheme can raise as a mortgage could be substantially reduced. For example, a SIPP can currently raise a mortgage of 75% of the purchase price. This will change to a maximum of 50% of the value of the SIPP fund pre-purchase. Smaller SIPPs will be particularly hard-hit.

Lifetime Allowance (LA)

Funds up to £1,500,000 in total can be accumulated within a client's pension plans without incurring tax on the excess. This LA will increase in increments up to £1,800,000 by 2010 at which point the Government will review it again. We do not expect the LA to keep pace with earnings over the long-term.

At retirement, funds in excess of the LA will be subject to a "lifetime allowance charge" (LAC). If taken as a cash lump sum the LAC will be 55%. If taken as income, the LAC is 25% and the resulting pension taxed as earned income at the individual's marginal rate. A higher rate taxpayer would therefore almost certainly take the cash as the total tax paid will be the same for either option.

Retirement

It will no longer be necessary to retire in order to draw pension benefits, although the minimum age to access pension funds will rise from age 50 to 55 by the 6th April 2010 (most providers are likely to allow retirement before 55 up to the 5th April 2010, then introduce the new age limit the following day).

Tax-free Cash

Tax-free cash will be 25% of all funds up to the then current lifetime allowance. This will represent an improvement for many employees.

Retirement Income

The choice remains between purchasing an annuity or drawing a pension out of the fund (pension fund withdrawal – PFW).

Annuities

The Government are keen to see product development in this area, if only to deflect criticism of an unpopular product. Early indications point to three main types of annuity;

a. Lifetime Annuities

These are annuities guaranteeing an income payable for life in exchange for one purchase price.

b. Fixed Period Annuities

These provide an income for five years at which point another annuity must be purchased. The advantage of fixed-period annuities is that money is retained within the pension fund for long term capital growth, until required, and annuity rates increase with age. However, the risk exists that market annuity rates in general could fall after retirement and/or investment growth is lower than anticipated.

c. Value Protected Annuities

In exchange for a lower annuity rate, these types of annuities will return the residual fund on the death of the annuitant to their estate, less a 35% tax charge.

We will, of course, closely monitor developments in the annuity market place and keep you advised.

Pension Fund Withdrawal (PFW)

PFW – up to age 75

The new rules offer increased flexibility. An individual can vary their pension from nil up to 120% of the best available single-life level annuity, which could have been bought with the same funds. The maximum will be reviewed every five years, rather than every three years as at present.

PFW after age 75

The compulsion to purchase an annuity at age 75 will be abolished. PFW can continue beyond age 75 until death and will be called "alternatively secured pension" (ASP).

The maximum ASP is reduced to 70% of the annuity that could have been purchased by a 75-year-old.

Upon the eventual death of the member, no lump sum is payable. The residual funds must be used to provide a dependants pension. If there are no surviving dependants, the funds could go to the member's nominated charity or re-allocated between the remaining scheme members.

It is important to note that the annuity rate against which the pension is tested will always be based on a 75-year-old, regardless of how much older the member actually is.

Death Benefits

Death Before Retirement

The whole of the member's fund up to the lifetime allowance may be paid out as tax-free cash to nominated beneficiaries. Any excess taken as cash will be taxed at 55%.

In addition, unlimited dependant's pensions may be provided, which will be taxed in their hands as earned income. We may well see a revival in the fortunes of death in service life cover as a result.

Death After Retirement but Before Age 75

The balance of the member's funds can be paid out as cash, less 35%. Alternatively, a taxable dependant's pension can be paid out of the fund or an annuity purchased.

Death After Retirement and After Age 75

See PFW after age 75 (Alternatively Secured Pension)

Transitional Protection

As we said earlier, for those new to pensions, these rules seem reasonable and understandable. The removal of compulsory annuity purchase at age 75 is particularly welcome. However, many people have already accrued sizeable pension benefits and they will be anxious to ensure that the new rules will not adversely impact on their long-term pension planning. Their concerns may centre on the size of their pension funds now or in the future and the possibility of the imposition of the lifetime allowance charge of 55%.

Alternatively, they may be anxious to ensure that their tax-free cash entitlement, currently in excess of 25% of the fund, is maintained. "Transitional protection" rules can be used to protect benefits accrued pre 'A Day' via either "Primary Protection or Enhanced Protection".

Comment

Clients with very large funds at A Day will probably choose not to make any further contributions and will opt for enhanced protection, which guarantees that the lifetime allowance charge will never apply at retirement. They will then explore alternative remuneration strategies to replace pension contributions no longer made.

Tax Free Cash Issues

The self-employed have, and will continue to enjoy, a tax-free lump sum of 25% of their accrued funds, up to a maximum of £375,000 (25% of the lifetime allowance). However, many people in occupational pension schemes (particularly SSASs) will have an entitlement at A Day to tax-free cash, either greater than 25% of their fund, or in excess of £375,000 (but not exceeding 25% of their fund).

In either case, the higher lump sum can be protected, but how depends on whether the individual is opting for primary protection, enhanced protection, or no protection at all and whether the lump sum at A Day is lesser or greater than £375,000.

Those clients who, from a tax free cash point of view, are better off under the old rules, can register their tax free cash entitlement for protection by having that figure calculated at "A" day and then appropriately registered.

If you do register for higher tax-free cash protection and then wish to surrender the pension plan in which it is held to another scheme after 6th April 2006 you will lose that protection. Many insured pension plans are still over charging their clients, compared to Stakeholder plans and with many insurance companies now closed to new business, their fund performance (particularly With Profits) could suffer. Your existing arrangements should therefore be fully reviewed and any changes made prior to A Day.

Summary/What to do Next

Unfortunately there is no "one size fits all" answer and each client will require individual advice. 2005 will be a busy year for pension advisors and the first and most important step is to identify those clients who will need advice. It would be of tremendous help to us if you could register with us your desire for individual advice if you think any of the issues raised in this newsletter could apply to you. To that end, we have enclosed a registration form to assist you.

INTEGRA ACCOUNTING LIMITED
CHARTERED CERTIFIED ACCOUNTANTS
5 STATION ROAD, HINCKLEY, LEICESTERSHIRE LE10 1AW. TEL: 01455 238551

AN APPOINTED REPRESENTANTIVE OF GREYFRIARS ASSET MANAGEMENT LLP.
AUTHORISED AND REGULATED BY THE FINANCIAL SERVICES AUTHORITY