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PENSION PLANNING FOR KEY EMPLOYEES

FINANCE ACT 2011 AMENDMENTS[1]

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These notes were prepared to accompany a lecture of 29 September 2011 given at the Old Court Room, Lincoln's Inn

1. There were considerable changes in the Finance Bill published on 31 March 2011 and now contained in the FA 2011.

2. The legislative changes are in section 65-72 and Schedules 16-18 FA 2011.

3. In addition there are eight sets of regulations and one Treasury Order to support the pensions tax reforms. The SI's all came into force on 11 August 2011. We are promised an updated RPSM in "approximately" late September.

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1 The views contained herein are put forward for further consideration only and are not to be acted upon without professional advice. The speaker can accept no responsibility or liability for any action or omission taken based on the information in these notes or the lecture.

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4. By way of background, once the coalition government had been elected, they soon announced a policy change on 22 June 2010, namely ending the requirement to purchase an annuity or otherwise secure a pension at 75.

5. Transitional rules were immediately introduced so that if a client reached 75 after that date they did not need to purchase an annuity until they were 77 – giving enough time for the government to consider the new rules they wanted to implement.

6. A change to the taxation relief afforded to registered schemes was already on foot with the Labour government's proposed High Excess Income Relief Charge contained in FA 2010 (which was to be introduced from 6 April 2011). This was repealed and after further consultation, the coalition government announced, on 14 October 2010, their proposed changes to pensions taxation.

7. The principle amendments announced on that date were restrictions to the annual allowance and lifetime allowances.

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CHANGES TO THE ANNUAL ALLOWANCE

8. The annual allowance covers the increase in a member's uncrystallised pension rights during the year.

9. The legislation defines the amount which is paid into registered schemes, together with additional entitlements accrued, as the "pension input amount". As a result of the changes introduced in FA 2011, the method of calculating the pension input amounts for defined benefit schemes or a cash balance arrangement (but not a money purchase arrangement) has changed.

10. The maximum level of the annual allowance increased from £215,000 in 2006/07 in each year to £255,000 in 2010/11.

11. FA 2011 Schedule 17 provides that a reduced annual allowance of £50,000 will apply from 2011/12 and onwards.

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12. There is, however, provision to amend this by Order. The original proposal that it would be fixed for three years with no indexation has been removed by the Finance Bill 2011.

13. There is a new three year carry forward rule that allows the carry forward of unused annual allowances from the last three years. This means that if the pension saving is more than £50,000 you may still not have to pay the annual allowance charge.

14. There is no blanket exemption from the annual allowance charge in the year benefits are taken or on redundancy. There is, however, be an exemption in the case of "serious ill health" or death. Following consultation, the definition of serious ill health in the Finance Act 2011 provisions is different from the FA 2004 standard definition.

15. This obviously affects all pension contributions and benefits built up on or after 6 April 2011.

16. However, it may also affect contributions made and benefits built up after 14 October 2010 (the date the changes were announced) depending when the pensioner's "pension input period" (or PIP) begins.

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17. The PIP does not have to be the same as the tax year. Therefore, you may have "a straddling PIP". Relief is available in Schedule 17 FA 2011 in these circumstances if your PIP began before 14 October 2010.

18. Therefore, all key employees must ascertain (usually through the scheme administrator) what the PIP is for their scheme.

19. For senior executives and high net worth individuals the constraints introduced in FA 2011 are very likely to present a problem at some point in their careers. In addition, consideration will need to be given by every pensioner and provider as to whether their contributions will be within the new limits imposed by FA 2011. Clients whose employer contributes to their plan may need to negotiate to reorganise their remuneration packages.

20. Also the Finance Act 2011 now provides for an individual to give notice to the scheme administrator for the individual's annual allowance charge to be paid from their pension benefits. A welcome result of consultation. This will be allowed where the individual has an annual allowance charge of more than £2,000. The downside, of course, is that in return

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there will be an appropriate reduction in the members pension benefits in that scheme.

21. Certain conditions must be met for such an election to be made and the result of the election will be that the scheme administrator becomes jointly and severally liable for the amount of tax specified.

22. Alternatively even if these conditions are not met, a pension scheme may be prepared to pay the annual allowance charge liability on a voluntary basis. If they do so, the member will still remain solely liable for the payment of the charge.

23. There are time limits in the legislation for when notification needs to be given to the scheme and when the charge needs to be paid by the scheme.

Transitional protection

24. The regime that applied from A-Day was different from all earlier regimes: it is retrospective. Accordingly, an important facility, particularly for high earners, was the provision of

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transitional protection for pre A-Day rights and entitlements.

25. A member could apply (before 5 April 2009) for enhanced or primary protection from the annual and lifetime allowances and for certain tax-free lump sums. From 6 April 2011 the exemption from the annual allowance for those with enhanced protections will no longer apply, very important change to note.

26. The regulation of the allowance takes place through the self-assessment process. Any excess is subject to the annual allowance charge. This is a freestanding charge which will be taxed at an individual’s marginal rates (not, as previously, at a fixed rate of 40%). So, at present, this can give rise to a charge at 50%. Another change from April 2011.

27. There are also new obligations on pension schemes to provide information at the earliest of six months after the end of the tax year to which the information relates, but only where the individual has pension savings greater than the annual allowance in that scheme or at the request of the scheme member. For the first year, schemes will be given an extra 12 months to provide the 2011-12 information.

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CHANGES TO THE LIFETIME ALLOWANCE

28. The lifetime allowance rates were, until the 14 October 2010 announcements:-

- 2006/07 £1,500,000
- 2007/08 £1,600,000
- 2008/09 £1,650,000
- 2009/10 £1,750,000
- 2010/11 £1,800,000

29. Another major change announced on 14 October 2010 was that the lifetime allowance will be reduced to £1.5 million from April 2012.

30. There will be a new form of protection called 'fixed protection'. This protection will be available to people who expect the amount of their pension savings to be more than £1.5 million when they come to take their benefits, but who do not have primary or enhanced

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protection. However, to keep this protection you have to meet certain conditions. These include:

- no new contributions can be paid to a money purchase arrangement
- the amount of benefits you can build up each year under a defined benefits arrangement or a cash balance arrangement will be limited
- you will not be able to open a new pension arrangement under a registered pension scheme, unless it is to receive a transfer of rights from an existing pension arrangement.

31. If you want to apply for fixed protection following the reduction in the lifetime allowance you have to make an application to HMRC **before** 6 April 2012. Act now to ascertain whether fixed protection appropriate. Form not yet available but will need to print it off and apply by deadline – you will not be able to apply online.

32. Anyone with existing primary or enhanced protection will continue to be unaffected by the reduction in the lifetime allowance.

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33. If you take a lump sum instead of a small pension this is known as 'trivial commutation'. The maximum amount of pension savings that can be commuted on grounds of triviality will no longer be linked to the lifetime allowance – from April 2011 it will be fixed at its current level of £18,000.

34. The combined effect of the restriction of the annual and lifetime allowances mean effectively that the maximum defined benefit entitlement an individual can have without breaching the limit is £75,000.

35. Where a client is a member of a final salary plan, they will need to discuss with their employer the likely value of their future pension benefits and what options are on offer to restructure their remuneration if they are likely to be affected.

CHANGES TO PENSION PAYMENTS AGED 75

36. A pension could only be paid in one of the following forms post A-Day:-

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- scheme pension (must be paid under a defined benefit arrangement)
- lifetime annuity
- unsecured pension before age 75 (income withdrawal or short term annuity)
- alternatively secured pension after 75 (income withdrawal).

37. However, from 6 April 2011 the effective requirement to buy an annuity by the age of 75 is removed and the alternatively secured pension rules are repealed. Broadly, from 2011-12 onwards the conditions for paying unsecured and alternatively secured pensions will change. The upper age 75 limit will also be removed from many types of lump sum payment.

38. The changes fall into four categories

• pensions

• lump sums paid to members

• lump sum death benefits

• lifetime allowance test at age 75.

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Pensions

39. The changes to the pension rules can only affect members of money purchase or cash balance arrangements not defined benefits (final salary arrangements).

40. The main changes are:-

- The tax rules for alternatively secured pensions are repealed.
- What are currently unsecured pensions and alternatively secured pensions are amalgamated into one form of pension – called **drawdown pension**.
- Drawdown pension comes in two forms called ‘capped drawdown’ and ‘flexible drawdown’.
- Capped drawdown works in the same way as income withdrawal before 6 April 2011. There is a maximum amount of pension that can be taken each year, and this amount is regularly recalculated.
- The maximum amount of capped drawdown pension (previously called income withdrawal) has changed. The amount of pension that can be paid is based around an equivalent annuity - this is called the ‘basis amount’. If you are under 75 the maximum amount of drawdown pension is reduced from 120 per cent to 100 per cent of the basis

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amount. If you are 75 or over the maximum amount has increased from 90 per cent to 100 per cent of the basis amount.

- There is no minimum amount of capped drawdown pension that has to be taken when the member or dependant is age 75 or over.
- The period for reviewing the calculation of the amount of capped drawdown pension before age 75 (the reference period) reduces from five years to three years. After 75 it is annually.
- With flexible drawdown there is no minimum or a maximum amount of pension that has to be taken each year. The member or dependant can take as much or as little from their pension fund as they like. There is no need for the scheme administrator to carry out regular calculations of the basis amount.
- To be able to have flexible drawdown the member or dependant must have at least £20,000 of secure pension in payment.

41. Therefore, from 6 April 2011 an individual with pension savings held in a money purchase arrangement in either a registered pension scheme or an overseas pension scheme (where the funds concerned have benefitted from UK tax relief) is able to withdraw those savings in their entirety as “flexible drawdown” pension income subject to meeting certain conditions.

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42. Where a UK resident individual takes flexible drawdown from a registered pension scheme, they can broadly receive a tax-free lump sum equal to 1/3rd of the value of the sums and assets used to provide flexible drawdown. Any amount taken as flexible drawdown is taxable in the year of receipt as pension income, under s.579A ITEPA 2003, at the individual's marginal rate (see EIM74014).

43. To prevent the possibility of someone avoiding tax by becoming temporarily non-resident for one full tax year or more and in that period taking flexible drawdown from a registered pension scheme or from an overseas pension scheme, FA 2011 introduced sections 576A and 579CA ITEPA 2003 so that flexible drawdown paid whilst an individual is temporarily non-resident in the UK is treated as pension income arising to the individual in the tax year they resume residence in the UK.

44. But where:

• the person is either not domiciled or not ordinarily resident in the UK in the year of return, and

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• the remittance basis, see SAIM1130, applies to that person for the year of return

• the charge is limited to amounts of flexible drawdown paid from a relevant non-UK scheme which were remitted to the UK in a year of non-residence. The remitted amounts are treated as remitted in the year of return.

45. In addition, both sections 576A and 579CA provide that this charging provision overrides the terms of any double taxation agreement.

Lump sum payment rules

46. The changes to the lump sum payment rules may affect members of any type of pension arrangement. You will not be affected by the changes if you intend taking all your benefits before you are 75.

47. The following types of lump sum can be paid after age 75

- pension commencement lump sum

- trivial commutation lump sum

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- stand-alone lump sum

- serious ill-health lump sum

- winding-up lump sum.

48. If a serious ill-health lump sum is paid when you are 75 or over it will be taxable at 55 per cent. The tax charge is on the scheme administrator and will be collected using the accounting for tax (AFT) return. This is new and introduced by a new section 205A FA 2006. An ill-health lump sum paid before 75 remains not liable to income tax, but counts towards the lifetime allowance.

Lump sum death benefits

49. The change to the lump sum death benefit rules could affect members of every type of pension scheme, whatever their age, if they die on or after 6 April 2011.

50. The following types of lump sum can be paid **after** age 75

- defined benefits lump sum death benefit

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- uncrystallised funds lump sum death benefit

- pension protection lump sum death benefit

- annuity protection lump sum death benefit

- unsecured pension fund lump sum death benefit (now called a drawdown pension fund lump sum death benefit)

- trivial commutation lump sum death benefit

- winding-up lump sum death benefit.

51. The following types of lump sum will be taxed at 55 per cent (up from 35%)

- pension protection lump sum death benefit if the member died after 5 April 2011

- annuity protection lump sum death benefit if the member died after 5 April 2011

- drawdown pension fund lump sum death benefit if the member dies after 5 April 2011.

52. A charity lump sum death benefit can be paid if the member (or dependant) died before they were 75. It can only be paid to a charity nominated by the member before they died. It will be noted that this results in a saving of 55% if charity relief applies, rather than a 40% IHT saving on gifts of other property, making a gift to a charity of a lump sum death benefit more

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tax efficient.

Lifetime allowance test at age 75

53. The change to the lifetime allowance test at age 75 only affects members of money purchase or cash balance arrangements. The changes to the test are confined to how scheme administrators operate it and pension scheme members should not notice any change.

54. Finally there are transitional arrangements if you received unsecured pension before 6 April 2011 and are not yet age 75.

INHERITANCE TAX

55. FA 2006 provided that monies held in an alternatively secured pension by an investor aged 75 or over would be subject to inheritance tax at 40% when the investor dies, deducted directly from the fund from the administrator.

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56. However, from 6 April 2011, IHT will not typically apply to drawdown pension funds remaining registered pension schemes, including where the individual dies after 75.

57. The replacement of unsecured pension and alternatively secured pension provision with a single drawdown pension therefore means that a number of inheritance tax charges no longer apply.

58. In addition, inheritance tax charges that arise when a member omits to take their entitlement under their pension scheme are removed by FA 2011. But not all inheritance tax charges that apply to pension schemes have been removed.

59. The inheritance tax charges that no longer apply to pensions are all charges that arise on pension funds left over on death, or on unauthorised payments from pension schemes and annuities. Section 151A - 151E IHTA 1984 have been repealed.

60. In addition, charges that arise where a scheme member omits to take their entitlements will

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no longer apply.

61. Typically, this will include:-

(1) failure to exercise a right where a member of a pension scheme is able to draw their retirement benefits, chooses not to do so whilst in ill health and then dies. This point was the subject of *D M Fryer & Others (Personal Representatives of Patricia Arnold Deceased) v HMRC* FTT [2010] UKFTT 87 (TC), TC00398.

(2) when a member commences income drawdown within two years of their death whilst in ill health and is therefore unlikely to survive to take their full benefits so, as a result, the balance of the pension fund will be paid outside their estate,

(3) whilst in income drawdown, ill health intervenes and the member reduces their level of drawdown, thus increasing the value of the pension fund paid to others on death, and

(4) where, in certain situations, a member has a right to request ill health retirement, but doesn't exercise that right, thus increasing the value of the pension fund paid to others on death.

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62. These changes take effect for deaths and omissions to exercise pension rights that occur on or after 6 April 2011.

63. A pensioner who already has an alternatively secured pension will have their pension converted to a drawdown pension and the new capped and flexible drawdown limits and rules will apply. There will be no inheritance tax charge on any lump sum that is payable following death, although this will be subject to an income tax charge (known as the special lump sum death benefits charge) of 55% under section 206 Finance Act 2004.

64. Inheritance tax charges will continue to apply to certain contributions made to pension schemes and where a member transfers their pension entitlement in ill-health. Charges will continue to apply in limited circumstances on death.

65. The charges that continue to apply to pension contributions and transfers of pension entitlement are where contributions are made to pension schemes by the member or their employer within two years of the death whilst the member was in ill health (See IHTM17042).

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66. But HMRC have stated that will only consider such a charge where an established pattern of contributions over several years has been altered in the knowledge that the member would not survive to enjoy the retirement benefit, thus enhancing the death benefit passing to the beneficiaries of the lump sum payment and there is a transfer of pension benefits within two years of the death by the member whilst in ill health, either by transferring from one scheme to another, including transfers to a QROPS, or by transferring their death benefits to a trust (See IHTM17072).

67. The charges that continue to apply on death are:-

(1) where the deceased could have, right up to their death, signed an nomination which bound the trustees of the pension scheme to make a payment to a person nominated by the deceased (but this does not apply to where the deceased could have signed a "letter of wishes") (See IHTM17083), so make sure they do!

(2) payments under a pension scheme or personal pension policy are guaranteed and continue to be paid to the estate after the deceased's death (this does not apply where

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the scheme replaces the deceased's pension with a reduced widow's, widower's or surviving civil partner's pension) (See IHTM17055),

(3) where pension scheme trustees have no discretion over the payment of lump sum death benefits which are paid to the deceased's estate (See IHTM17081),

(4) where the scheme contained a protected rights element, and there is no surviving spouse or civil partner, dependants or nominated beneficiaries, so that the lump sum is paid to the deceased's estate (See IHTM17131).

68. Where an inheritance tax charge does arise on death, it will be on top of any 55% special lump sum death benefits income tax charge under section 206 Finance Act 2004. This will result in a composite charge of 73% charge.

69. Finally, there has been no change to any inheritance tax charges that arise on unregistered pension schemes or EFRBS.

QROPS

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70. The relaxation in the transfer rules under the post A-Day regime has widened the scope to make transfers to and from registered schemes considerably.

71. Many of the changes and relaxations relating to overseas matters will be of particular interest to high earners, who are more likely to be investors overseas, members of overseas schemes and or the internationally mobile.

72. The post A-Day regime has removed many of the obstacles within the EU member states and other acceptable overseas pension benefit providers, ensuring the protection of members benefits and the widening of the availability of tax reliefs.

73. Migrant member relief gives tax relief on contributions made to a qualifying overseas pension if the member has relevant UK earnings. A relevant migrant member is a member who belongs to an overseas pension who was not resident in the UK when he joined the scheme and was a member of the scheme at the beginning of his residence in the UK. He must have received tax relief in his former country of residence.

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74. The UK set out the requirements of “an overseas pension scheme” by section 150(7) of the Finance Act 2004 (“FA 2004”) (the meaning of overseas pension scheme) and the Pension Schemes (Categories of Country and Requirements for Overseas Pension Schemes and Recognised Overseas Pension Schemes) Regulations 2006 SI 2006/206 (“the 2006 Regulations”).

75. In order to be a qualifying overseas pension, broadly, the scheme manager must notify HMRC of the scheme status and undertake to inform HMRC of certain matters in relation reporting and to comply with certain requirements. The scheme must be EEC registered or one that generally corresponds with a UK scheme (i.e at least 70% of the sums transferred will be designated by the scheme manager for the purpose of providing the member with an income for life and benefits are payable no earlier than s165 FA 2004). Employers may claim a deduction in respect of migrant workers.

76. There are, in addition, further conditions to be satisfied, namely that the scheme is open to persons resident in the country in which it is established and broadly tax relief is not available on contributions or all or most of the benefits paid by the scheme to members not

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in serious ill health are subject to taxation (the primary conditions).

77. Finally the scheme must be approved or recognised or registered with the relevant tax authorities as a pension scheme or if there is no such system, it must be resident and be broadly similar to UK pension rules (Conditions A and B).

78. There may be an unauthorised payments charge if an individual whose rights are transferred to a QROPS receives a payment unless he is non-resident in that year and the previous five years. Scope for planning for expats or where individuals leaving the UK.

QNUPS

79. In addition, the Inheritance Tax (Qualifying Non-UK Pension Schemes) Regulations 2010, SI 2010 / 0051 ("the QNUPS Regulations") came into force on 15 February 2010 and have introduced QNUPS (see below).

80. The purpose of the QNUPS regulations was to correct an error in the Finance Act 2004.

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Without these amending regulations UK pension funds, once transferred to a QROPS, would arguably become liable to UK Inheritance Tax (IHT) charges. These regulations now mean a non-UK resident may transfer UK pension rights to a QROPS and upon death, whether before or after age 75, no inheritance tax liability arises.

81. These regulations apply to overseas schemes generally.

82. To be a QNUPS the overseas scheme must satisfy the same conditions necessary for a Recognised Overseas Pension Scheme (ROPS) (SI 2006/206) with the important exception that there is no necessity for there to be a double taxation treaty with the overseas scheme's jurisdiction if the scheme is outside of the European Economic Area. A DTA is not necessary because there are no reporting requirements from the QNUPS to HMRC.

DISGUISED REMUNERATION PROVISIONS

83. FA 2011 introduces in Schedule 2 a new Part 7A of ITEPA 2003, the disguised remuneration provisions. Section 554E ITEPA contains exclusions in relation to various pension schemes

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including “Chapter 2 [the treatment of a relevant step for income tax purposes] does not apply by reason of a relevant step of the step is taken under any of the following … (g) a registered pension scheme”.

84. In addition, section 554S provides that Chapter 2 does not apply by reason of a relevant step within 554C or 554D (payment of sum, making asset available) if the step is the provision of pension income which is chargeable to income tax under Part 9 ITEPA or is exempt income.

85. Sections 554T-554X contain further provision relating to retirement benefits and are to be applied, as far as applicable in that order.

86. Section 554T provides an exclusion in relation to certain employee pension contributions, section 554U in relation to pre 6 April 2006 contributions to e-furbs, section 554V in relation to the purchase of annuities out of pension scheme rights, section 554W in relation to pre 6 April 2011 lump sum rights and section 554X in relation to transfers between foreign pension schemes. Finally, 554Y gives HMRC the power to exclude other relevant steps by regulation.

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87. Also consider whether earmarking can be avoided especially with regard to final salary and/or defined benefit schemes.

88. Draft regulation: The Employment Income Provided Through Third Parties (Excluded Relevant Steps) Regulation 2011 – comments by 30 September 2011.

ACTIONS: REVIEWING EXISTING SCHEMES

89. The changes in FA 2011 to the annual allowance and the lifetime allowance mean that many clients will need to change their contribution rates to stay within the revised allowances. If the employer contributes there may need to be a renegotiation of the remuneration package.

90. Consideration may need to be given by those with enhanced protection to its loss in relation to the annual allowance.

91. A decision will need to be taken before 6 April 2012 as to whether to apply for fixed protection from the lifetime allowance if primary or enhanced protection does not apply.

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92. Members need to ascertain their likely lifetime provision and restructure remuneration accordingly.

93. Also, from a tax planning perspective it is advisable to review existing documentation and arrangements regularly, particularly if there is a possibility of utilising a QROPS or a QNUPS or double taxation relief.

94. Note that section 72 FA 2011 "ensures that the UK's network of tax treaties cannot be used by a UK resident to avoid UK tax on a foreign pension or lump sum".

FUTURE CHANGES

95. Changes to state pension.

96. Changes to public sector pensions.

97. Consultation on access to funds: the next big step.