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sackers extra

Tax Simplification – the hidden costs

From "A-Day" (6 April 2006), the eight tax regimes applicable to occupational and personal pensions will be replaced by a single uniform set of allowances. But what effect will stripping away current Inland Revenue limits ("IR limits") have on pension promises? Whilst A-day may seem a long way off, trustees and employers of occupational pension schemes need to start considering the potential cost ramifications of this question now. Here we briefly consider why.

The new regime

In a nutshell

- From A-Day, there will be two pensions allowances, the Lifetime Allowance ("LA"[1]) and the Annual Allowance ("AA"[2]).
- Benefits above the LA will be subject to a 25% "recovery charge" (or 55% if taken as a lump sum).
- Contributions above the AA will be subject to a 40% surcharge.
- All "approved" schemes will be automatically "registered" for the purposes of the new regime.

Removing existing limits

Why it matters after A-day

- After A-day, IR limits as we know them will disappear.
- The very removal of these limits could inadvertently increase scheme liabilities.
- The Bill envisages transitional relief so schemes can start the new regime as if IR limits (including the earnings cap) still apply.
- But this relief may not work for all schemes and will only be short-lived, lasting until the first time scheme rules are changed or 5 April 2009, if later.

Earnings cap

Effect on pension

- Members who joined schemes from June 1989 are generally subject to the "earnings cap" (£102,000 for tax year 2004/05).
- Once this limit goes, members' salary for calculating benefits could unintentionally become uncapped.

Effect on death benefits

- Death-in-service benefits are also generally limited to 4 times capped salary.
- Once this concept vanishes, schemes could find themselves liable for higher (and potentially uninsured) payouts.

1 Initially £1.5 million, rising each year until it hits £1.8 million by 2010
2 Initially £215,000, rising each year until it hits £255,000 by 2010

Unlimited retirement benefits

Long-service/high earners

- The current IR maximum pension is broadly two-thirds "Final Remuneration".
- In some schemes, benefits of long-serving and/or high earning individuals may be kept in check by this maximum.
- Once it goes, costs could potentially spiral.

Pension Increases

Effect of removing limit

- IR limits restrict increases on pensions in payment to the greater of 3% or the increase in the retail prices index (RPI).
- Historically, some scheme rules refer to flat rate 5% increases (well above the current rate of inflation).
- Such schemes could therefore see a sudden jump in the level of pension increases when the 3%/RPI limit is removed.

And finally beware

New rights to retire early

- From 2010, a member cannot draw pension before age 55 (excepting ill-health).
- Relief will be available where a (private sector) member has a right under his occupational scheme to retire sooner, provided that right exists from 10 December 2003 through to A-day.
- Employers and trustees need to be careful not to grant new rights to retire before 55 now (e.g. in a scheme booklet), unless the right is only exercisable before 2010.

Action required

- These are just some of the areas which need careful thought before A-day.
- Employers and trustees, together with their advisers, should start considering how the demise of IR limits will impact on their scheme.
- Subject to section 67 considerations, possible action may include rethinking scheme design or alternatively amending scheme rules to retain, where permissible, limits akin to IR limits.

This edition of Sackers Extra News is one in a series produced by our Pensions Reform Team, providing information to help you react and respond to developments in the simplification and reform of pensions.

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