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# Pensions and Tax – to simplify or not to simplify?

## 1 INTRODUCTION

The Government has just issued its latest consultation paper on tax simplification "Simplifying the taxation of pensions: the Government's proposals". The paper was published immediately after Gordon Brown's pre-budget report delivered on 10 December 2003 and follows on from the first consultation paper issued on 17 December last year[1].

Whilst the paper reaffirms some of the Government's key simplification proposals (such as its intention to introduce a lifetime limit) it also raises the (somewhat alarming) possibility of the current eight different tax regimes remaining in place. The Government's aim is to achieve general consensus to the changes being put forward before proceeding from April 2005 ("A-day"). An announcement will be made in the 2004 Budget on whether or not the simplified regime will be introduced, once the National Audit Office has reported on the numbers affected by the proposed simplification.

Some of the main points arising from the Government's consultation paper are summarised below. Comments on the consultation are invited by 5 March 2004.

## 2 THE SIMPLIFIED REGIME

The Government believes that removing "the existing plethora of controls" from the current tax regime "would make pensions easier to understand and cheaper to operate". With this in mind, the Government proposes to:

- replace current limits on benefits and contributions to pension schemes with a single lifetime limit of £1.4 million (generally assessed at retirement), increased in line with the retail prices index (RPI)[2];

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[1] Simplifying the taxation of pensions: increasing choice and flexibility for all

[2] Gordon Brown also announced the intention to introduce a harmonised "Consumer Prices Index"

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- set the rate for converting defined benefit schemes into a capital sum for the purposes of the lifetime limit "at £20 for every £1 of pension";

- allow a tax-free lump sum of up to 25% of benefits below the lifetime limit (any excess over the limit could also be used to take a lump sum, subject to a 55% tax charge). The present limit of £150,000 for persons who joined their current plans after March 1987 will be removed, effectively raising the possible lump sum to £350,000 where the maximum benefit has been accrued;

- impose a "recovery charge" on the excess over the lifetime limit at the rate of 25%, unless taken as a lump sum (although the recovery charge will be "assessable on the member", registered schemes will need to withhold benefits to cover it);

- complement the above with a "light touch annual allowance" of £200,000 (again, increased in line with RPI). This limit will not apply in the final year provided that benefits come into payment in full to avoid catching redundancy enhancements;

- the annual allowance will be assessed on contributions to defined contribution schemes and on "the deemed *capital value* of the increase in the member's pension entitlement from one scheme year to the next" in defined benefit schemes (a factor of £10 in value for each £1 of pension will be applied).

The new limits will generally apply to everyone saving for a pension through a "registered pension scheme", regardless of the type of scheme. (Specific provisions will apply to benefits relating to pension sharing on divorce). The assumption is that currently approved schemes will automatically become "registered" from A-day, unless they opt out.

Employers may continue to provide benefits through top-up arrangements such as FURBS (funded unapproved retirement benefit schemes) and UURBS (unfunded unapproved retirement benefits schemes) but they will not benefit from any favourable tax treatment. (Sums held in FURBS at A-day will, however,

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receive some protection). FURBS and UURBS will not be tested against the annual or lifetime limits and no recovery charge will apply to them. The future existence of such schemes may well depend therefore on whether they can be used to provide alternative benefits which cannot be offered through a registered scheme.

All existing requirements to carry out funding reviews and to reduce pension surpluses will also disappear from A-day.

## 3 PENSIONS AGE

Recognising that people are working longer (and need to be encouraged to do so given increased life expectancy), the Government is committed to increasing the minimum age at which pension can be taken from 50 to 55 by 2010. Schemes will generally be free to decide how and when to phase in the change prior to then. However:

- there will be protection for deferred and active members who had a contractual right to take a pension after age 50, provided that right still existed before 10 December 2003;
- members of pension schemes at A-day who have existing rights to a low normal retirement age will, subject to certain conditions, be able to retain those rights.

It will still be permissible to pay incapacity pensions but medical evidence will need to be retained so that the Revenue can inspect it (the driver for this measure seems to be the prevention of unauthorised payments).

## 4 PROVISION OF BENEFITS

In addition to the changes outlined above, pension benefits must:

- commence before age 75;

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- be paid at least annually for life;
- be non-assignable (other than in permitted circumstances);
- not be guaranteed for a period in excess of 10 years.

Pensions will be provided, as now, by either purchasing an annuity or by paying a pension through the scheme. There will also be a new method, "Alternatively Secured Income", which appears to be a form of income drawdown under which income will be protected by applying certain annual limits on the level of benefits taken.

As regards death benefits, secured pensions may offer "value protection". This is different from a pension guarantee in that it provides for the repayment of a capital sum "representing the initial capital value of the pension less any pension instalments". Such a benefit, which will attract 35% tax, can only be paid if the member dies before age 75. If a member dies before pension comes into payment, it will be possible to pay dependants' benefits either as a pension (which will be taxed in the usual way) or as a lump sum (subject to the recovery charge if the lifetime limit is exceeded).

## 5 INVESTMENTS AND ADMINISTRATION

The Government is keen to adopt a "single set of investment rules for all pension schemes". The rationale behind relaxing current investment requirements is to allow schemes "to invest in all types of asset with minimal interference from tax rules". The 5% restriction on self-investment (for example, holding shares in the sponsoring employer) will stay. But suggested changes include allowing schemes to invest in assets which members can benefit from personally, such as residential property, subject to a "pension benefit in kind charge".

The aim is to ease administrative burdens, with a registration process replacing the current Inland Revenue approval system. Plans are also afoot to help

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reduce the volume and frequency of information collected not only by the Inland Revenue but also by OPRA (the Occupational Pensions Regulatory Authority) and its successor.

## 6 TRANSITIONAL ISSUES

Various measures will be put in place to facilitate the transition into the new regime.

Individuals whose pension rights exceed the lifetime limit (£1.4 million) at A-day can protect those benefits by registering them. The registered benefits will be expressed as a percentage of the lifetime limit (the example given is that a benefit of £2.1 million will be registered as 150%). The benefit will then be index linked in line with the lifetime limit. Using the same example, this means that the individual will be able to take benefits of up to 150% of the lifetime limit applicable in the year in which pension comes into payment without incurring a recovery charge (this percentage will also follow through into the level of tax-free lump sum available).

An alternative method for safeguarding accrued benefits (whether they exceed the lifetime limit or not) involves the member suspending pensionable service (and ceasing contributions) before A-day.

To benefit from these protections, rights will need to be registered within 3 years of A-day (i.e. probably by 6 April 2008).

## 7 CONCLUSIONS

There is clearly still a lack of consensus within the Government as to the level of the lifetime limit. To tie agreement on this to the fate of the rest of the simplification measures seems unhelpful. If you would like to comment on the proposals, the consultation paper is available at http://www.inlandrevenue.gov.uk/pbr2003/simplifying-pensions.pdf.