Pensions – the new tax regime

Monmouthshire Independent Financial Advisers
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a Monmouthshire Building Society Group Company

Pensions – the new tax regime

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INTRODUCTION

One of the biggest changes ever made to the UK pensions system took place on 6 April 2006 – designated A-Day by Her Majesty's Revenue and Customs (HMRC). The process has been described as 'simplification' of the tax rules, and in many respects the description is accurate. But a number of aspects of the new regime are very complicated, in particular the transitional or changeover provisions as they apply to people with relatively substantial pension rights.

The main tax privileges that pensions have long enjoyed will broadly remain in place:

- Contributions into pensions by employers, employees and self-employed people will continue to qualify for full tax relief.
- The funds will be free of tax on capital gains and investment income, apart from the tax credit on UK dividends, which will stay non-reclaimable.
- The retirement benefits will remain available in part as a tax-free capital sum and in part as a taxable lifetime income.

The legislation is contained in the 2004 and 2005 Finance Acts, subsequent regulations and, in draft, in the Finance (No 2) Bill 2006. The new regime is potentially still subject to change; at least until this year's Finance Bill receives Royal Assent. However, the main aspects of the new regime are now firmly established.

Anyone accruing pension benefits – and even a number of those already drawing them – should look at their position in the light of these major changes. It is important to get competent professional advice because of the complexities involved.

THE CORE HMRC PROPOSALS

The key to HMRC's approach has been the introduction of a single new pension tax regime to replace all the previous approved regimes, including retirement annuities, and unapproved pension schemes. Although there are many transitional arrangements, the old pension regimes have disappeared. HMRC say that the result has been to reduce eight sets of pension rules to just one.

For the vast majority of pension scheme members, the changes have made pensions much simpler and easier to understand. A small minority, estimated initially at about 10,000, have been affected by the new lifetime allowance.

Probably the easiest way to understand the new structure is to examine its key components and then consider the transitional arrangements that apply.

What is the lifetime allowance?

In place of the former earnings cap (£105,600 in 2005/06 and notionally £108,600 in 2006/07), you are entitled to accumulate a maximum total amount of £1.5 million in tax-favoured pension funds. HMRC claim that the £1.5 million is broadly equal to the cost of providing maximum occupational scheme benefits for a 60 year old with earnings equal to the earnings cap.

However, this is only on the basis adopted by HMRC, which has chosen a 20:1 factor for converting post A-Day scheme pensions to cash (£1.5 million = £75,000 x 20). If you were to buy the corresponding £75,000 lifetime annuity from an insurance company, you could expect to pay around £2.3 million at current rates.

If you are in a defined contribution (DC) pension arrangement, in most cases the lifetime allowance simply applies to your total pension fund. If you are in a defined benefit (DB) scheme, for the purpose of checking against the limits, your final pension is converted to a fund using the 20:1 conversion factor.

The lifetime allowance will rise in stages to £1.8m in 2010/11. After that, increases will be determined by the Treasury, probably for five yearly periods. The fact that in the early years the allowance will rise at a rate faster than expected inflation will initially limit the increase in the number of people affected by it.

How does the lifetime allowance charge apply?

If you have a fund of more than the standard lifetime allowance when you take your benefits, the excess will be subject to a 'lifetime allowance charge'. If you take the excess as cash, the charge is 55%.

The lifetime allowance charge is reduced to 25% if you use the excess to provide additional retirement income. However, since this income would itself be subject to income tax (probably at 40%), the likely overall effective tax rate would remain at 55%, ie (100% - 25%) of the lifetime allowance charge x 40% + 25%.

Example 1: Exceeding the lifetime allowance

Graham reaches retirement with total pension funds worth £2.5m. At the time, the lifetime allowance has risen with inflation to £2m. Assuming that Graham does not qualify for any transitional reliefs, he has two ways of dealing with the £500,000 excess:

- He can draw £225,000 as cash, with the balance of £275,000 representing the lifetime allowance charge.
- He can use £375,000 to buy an annuity or start income drawdown. The balance of £125,000 is taken as the lifetime allowance charge and the income Graham receives will also be taxed.

The lifetime allowance charge makes overfunding pensions a tax-inefficient option. However, it could be difficult to avoid overfunding. For example, if your pension fund were to grow rapidly in the last year before you drew benefits, you could find that HMRC might take 55% of much of the growth.

What is the annual allowance and how does it apply?

Your pension arrangements are subject to a total annual tax-efficient contribution limit of £215,000 in addition to the lifetime allowance. This contribution ceiling will rise by £10,000 a year to £255,000 by 2010/11. Thereafter, increases will be determined by the Treasury, like the lifetime allowance.

The £215,000 annual allowance is the combined amount that you and any employer can contribute to your pension during a year without a tax penalty. As an employee or self-employed person, you can contribute the greater of £3,600 or 100% of your earnings, with tax relief. Contributions made by your employer gain automatic tax relief, subject to the normal Taxes Act rules on allowable expenditure.

For active members of final salary (defined benefit) pension schemes the contribution is calculated as the increase in value of the employees' pension benefits during the course of the year. HMRC values accruing benefits on a 10:1 basis in place of the 20:1 ratio used at retirement.

For deferred members of final salary schemes – ie those who have benefits in a scheme that they have left – it is generally only the increase over and above inflation-proofing (or 5%, if greater) that counts as a 'contribution' for these purposes. So deferred scheme members will not be caught by the annual allowance, unless their prospective pension benefits (after inflation adjustment) increase by more than £21,500 in 2006/07 (£21,500 x 10 = £215,000).

For members of money purchase pension arrangements (including personal and stakeholder pensions), only the contributions made by the employer or employee in the scheme year count. Any investment growth (or loss) in the value of the fund is ignored, as are any National Insurance Contribution contracting out rebates.

If the total contributions to your pension exceed the annual allowance – even if they are all personal contributions within the 100% of earnings limit – you will be subject to an annual allowance charge of 40% under self-assessment on the excess contribution. The contributions remain within the pension arrangement, and you could therefore face a further tax charge when they come to be used to provide benefits. Exceeding the annual allowance is therefore tax-inefficient and best avoided. There is one occasion when the annual allowance does not apply to contributions to a scheme. That is any year when you take benefits in full from that pension scheme. This relaxation prevents the limit from biting if the value of your benefits were to jump because you retired early on favourable terms or took early retirement because of ill-health.

In practice, the annual allowance is much more generous than the former contribution limits for all but the highest earning members of occupational pension schemes. For example, in 2005/06 the maximum annual contribution to a personal pension (if you were born before 7 April 1944) was £42,240 (ie 40% of the £105,600 earnings cap).

Example 2: Exceeding the annual allowance

Norma, aged 55, is a member of a non-contributory final salary pension scheme. In 2007/08 she is promoted to the main board and her salary rises by £45,000. Her prospective pension increases correspondingly by £25,500 a year because she has been a member of her employer's scheme for 35 years. The annual allowance during the year is £225,000.

The deemed value of the contribution during the year is:

£25,500 x 10 = £255,000.

Norma therefore has to pay 40% tax on the £30,000 (£255,000 – £225,000).

Planning note *It would be possible to avoid the annual allowance charge by making about £5,300 of Norma's pay increase non-pensionable for its first year of payment. This would limit her pension increase to £22,500. In the following year, 2008/09, the extra salary could become pensionable without causing any tax charge, unless Norma had another substantial salary increase.*

What are the rules for a person's retirement age?

The concept of a normal retirement age has disappeared under the new tax rules, as has the old constraints on employees drawing occupational benefits while they remain employed. However, from 6 April 2010, there will be an increase in the minimum age at which you can draw benefits from 50 to 55.

How large can the tax-free cash sum be?

The general limit for tax-free cash – now called pension commencement lump sum – when benefits are drawn is simply 25% of the value of your total benefits for any pension arrangement. This includes Protected Rights, ie funds built up from contracting out of the State Earnings Related Pension Scheme (SERPS) and/or the State Second Pension (S2P) via a personal pension or money purchase occupational scheme.

Additional voluntary contributions (AVCs) and free-standing AVCs can provide tax-free cash directly, something which was not normally permitted under the previous rules.

There is no cash ceiling on the amount of tax-free cash, other than the initial £375,000 stemming from the maximum 25% of the £1.5m lifetime allowance.

Example 3: Tax-free cash

Altaf reaches retirement at age 60 with an occupational scheme fund worth £200,000, a retirement annuity worth £40,000 and personal pensions worth £60,000. Assuming that Altaf does not qualify for any transitional reliefs, the maximum tax-free cash he can draw from each is:

Occupational scheme:	£200,000 @ 25% =	£50,000
Retirement annuity:	£ 40,000 @ 25% =	£10,000
Personal pension:	£ 60,000 @ 25% =	£15,000
Total		**£75,000**

Under the old regime, there would have been three different calculation bases, although the personal pension maximum would be 25% of fund.

If you have joined an occupational pension scheme since 17 March 1987, you should gain from the 25% of fund calculation, unless the total contributions made to the scheme are relatively low. In contrast, under the old rules, the tax-free lump sum was the equivalent of only 12%-15% of the accumulated fund for a member of a typical final salary scheme, building up a pension at a rate of 1/60th for each year of service, according to one estimate. Similarly, in virtually every case, there is an increase in the maximum cash you can draw from a retirement annuity (the predecessors of personal pensions). However, pension schemes and providers are not be obliged to pay the new maximum tax-free cash sums, and it is possible that at least in the short term some will retain their old basis within their specific scheme rules, provided it does not breach the new 25% limit.

The downside of the change is that it marks an end to the scope for occupational schemes to fund mainly or solely for cash. In addition, many of the defined contribution schemes recently established to replace final salary arrangements will pay out less cash, because their average employer contribution levels are only about 6%. At such modest contribution levels, the old tax rules allowed more than 25% of the fund to be drawn as cash.

What are the death-in-service benefits?

The maximum death benefit payable before retirement benefits are drawn is a lump sum equal to the lifetime allowance. All the complex salary-related constraints that previously applied to occupational schemes have disappeared. If the total amount of life assurance and other benefits available exceeds the lifetime allowance when a person dies:

- Any excess paid as a lump sum is subject to the 55% lifetime allowance charge, payable by those who receive the benefits.
- But any excess used to provide dependants' benefits (eg annuities) is not subject to a lifetime allowance charge.

Example 4: Death-in-service benefits

On Kate's death in January 2011, her pension plans and pension life cover are valued in total at £2.2m. By that time the lifetime allowance has increased to £1.8m. Assuming that Kate did not qualify for any transitional reliefs, the pension plans can provide:

- A lump sum of £2.2m, on which there would be a lifetime allowance charge of £220,000 (£400,000 @ 55%); or
- Dependants' pensions with a value of £2.2m and no lifetime allowance charge; or
- A lump sum of £1.8m plus dependants' pensions with a value of £400,000 (and no lifetime allowance charge).

In theory, survivors' pensions can be provided instead of any lump sum under the lifetime allowance, but it is hard to see why this option would be chosen where benefits are below the lifetime allowance unless dependants' pensions had to be paid, eg under contracting-out rules or scheme rules. A tax-free lump sum provides more flexibility and, if income were required, the capital could be used to buy a purchased life annuity, which has tax advantages over its pension counterpart.

At present, many occupational schemes, particularly final salary schemes, offer dependants' pensions and a lump sum on death-in-service. Under the new regime, such schemes are now under pressure to pay only a (larger) lump sum.

How can income be drawn from pension schemes?

There are four different methods of drawing income from your pension arrangements:

1. *Scheme pension payments* are pension payments made directly by pension schemes. Death benefits after retirement can take the form of either traditional guarantee periods of up to ten years or 'pension protection' (also called capital protection). Under pension protection, the maximum lump sum payment on death before age 75 would be the original pension value, *less* gross income payments made, *less* a 35% tax charge. Alternatively, final salary pension schemes will be able to offer a tax-free lump sum as if the pensioner were still an employee. Lump sum payments will not normally be permitted on death after age 75. Defined benefit schemes are only allowed to make scheme pension payments.
2. *Lifetime annuity payment* are pension payments in respect of money purchase schemes made by authorised insurance companies. These are subject to the same type of death benefit options as scheme pension payments.

Example 5: Annuity protection on death

Five months after his 65th birthday, Simon uses his £150,000 pension fund to buy an annuity with annuity protection, providing him with a gross income of £10,000, payable yearly in arrears. At age 74½, Simon dies one month after receiving his ninth income payment. Under annuity protection, the lump sum payment will be:

Purchase price of annuity	£150,000
Less total gross income received	(£ 90,000)
Gross lump sum death benefit	£ 60,000
Less tax at 35%	(£ 21,000)
Net lump sum	**£ 39,000**

If Simon died after reaching age 75, but before the next annuity payment was due, there would be no lump sum payment.

3. *Unsecured pension* is only available from money purchase schemes, and includes withdrawals directly from a pension fund. The maximum annual income under the unsecured option that can be drawn from your accumulated fund is 120% of the highest level of income that could be drawn from the fund based on the Government Actuary's Department (GAD) annuity tables. This maximum is similar to the limit that applied to income withdrawals before A-Day. There is no minimum withdrawal set by HMRC – so you need not take any income.

- By age 75, you must either buy a lifetime annuity or a scheme pension or switch to an alternatively secured pension (see below).
- As an alternative to fund withdrawals, part of the fund could be used to buy a fixed annuity for a maximum term of five years (but not beyond age 75). The maximum income would be the same 120% of the GAD annuity amount.
- Death benefits before age 75 are the same as applied to pension fund withdrawals previously, ie a return of the remaining fund on death, subject to a 35% tax charge. Alternatively, the whole fund could be used to provide dependants with pensions or continued withdrawals. In a change of heart, HMRC have confirmed that death benefits will normally be free of inheritance tax.

4. *Alternatively secured pension (ASP)* is a new option which is only available from money purchase arrangements. This is a restricted form of income withdrawal only available from age 75. ASP was originally proposed to meet the needs of certain religious groups that have ethical objections to annuities, but in practice it has become regarded as a restricted means of extending income withdrawal beyond age 75. The maximum ASP withdrawal is only 70% of the GAD annuity tables figure and reviews will be annual, but based on GAD rates for age 75.

   Funds remaining on death must in the first instance provide pensions for dependants. If there are no dependants, then the funds may be transferred to a nominated charity or pass to another nominated member of the pension scheme. Where funds are passed to a nominated individual, either on the member's death or on the subsequent death of a dependant, the value transferred will be treated as part of the member's estate for inheritance tax purposes.

What are the restrictions on pension scheme investments?

The new regime has removed some of the previous restrictions on pension scheme investment. All schemes are now broadly subject to the same investment rules. The special rules for small self-administered schemes (SSASs) and self-invested personal pensions (SIPPs) have disappeared, including the requirement for SSASs to have a pensioneer trustee. Transactions between pension schemes and their members are now possible (eg you could sell to your SIPP a commercial property that you personally own). However, tax penalties will apply unless all dealings are on an arms length basis.

There has been a tightening of the rules in some areas:

- The total holding of shares by an occupational pension fund in a single sponsoring employer must be less than 5% of fund value, compared with the previous 50%.

- Loans to employers, other than in the form of bonds issued on the open market, must:
  - Not exceed 50% of the net value of the fund at the date the loan was granted.
  - Be secured as a first charge on assets that must initially have a value at least equal to the loan.
  - Charge a minimum interest rate currently set out in draft regulations as 1% over the average base rate of the six main clearing banks, rounded up to the higher 0.25%.
  - Normally last for no more than five years, during which time they will be repaid by equal annual instalments. However, it is possible to roll over loans for a further five-year period if the employer is having difficulties in meeting payments due.
- Borrowing by a pension scheme are limited to 50% of the net scheme assets, eg a fund with net assets of £200,000 may borrow £100,000.

The Finance (No 2) Bill 2006 makes it clear that residential property and personal chattels (eg art and antiques) will normally be regarded as 'taxable property'. This category of investment incurs penal taxation for both the member and the scheme and is to be avoided.

How are unapproved schemes taxed?

Unapproved schemes (which have been renamed 'employer-financed retirement benefit schemes') receive no tax privileges under the new regime. For what were funded unapproved retirement benefit schemes (FURBS) this means:

- You are not taxable or subject to NICs on employer contributions.
- Your employer does not receive any tax relief for their contributions until you have started to receive benefits.
- Investment income and capital gains within the fund are liable to tax at a rate of 40% (32.5% for dividends). Capital gains have been taxable at 40% since 6 April 2004 under general trust taxation reforms.
- All benefits are liable to income tax, but will normally be NIC-free.
- Death benefits are potentially subject to IHT.

If you are a member of an unfunded unapproved retirement benefit scheme (UURBS), the situation is unchanged. Your employer will receive tax relief on benefit payments and you will pay income tax on them.

Unless any transitional reliefs are used, neither UURBS nor FURBS count towards the lifetime or annual allowances, nor are they subject to any lifetime or annual allowance charge.

TRANSITIONAL PROVISIONS

Not all vestiges of the old regimes disappeared immediately on 6 April 2006. There is a raft of transitional arrangements that apply to people's rights and benefits acquired before A-Day. These include:

What happens if the lifetime allowance is exceeded?

If the value of your benefits and rights on 5 April 2006 exceeded the lifetime allowance, you have three years from A-Day in which to register them with HMRC. Such rights can be protected in two ways:

- *Primary protection* The value of your A-Day rights is revalued in line with the rise in the lifetime allowance. Any excess over this amount at the time of drawing your benefits will suffer a lifetime allowance charge.
- *Enhanced protection* You must normally have ceased active membership of all your pension arrangements before A-Day. Thus it may already be too late to choose this option. If you do, all benefits (calculated on the pre A-Day basis) are then free from a lifetime allowance charge. If you choose this option and also elect for primary protection, then you can switch to primary protection at any time before your 75th birthday by sending a written revocation of enhanced protection to HMRC.

Example 6: Primary protection and enhanced protection

On 5 April 2006, Julia is a member of a SSAS with a fund of £1.8m. She registers this with HMRC and contributions to the scheme cease. Nine years later, when her fund is worth £3m, she decides to draw her retirement benefits. The standard lifetime allowance at that time has risen by 50% to £2.25m.

- *If she has chosen primary protection,* she is allowed to draw benefits up to a value of £2.7m (£1.8m x 150%) without any lifetime allowance charge. The balance of £0.3m is subject to a lifetime allowance charge before any benefits are taken.
- *But if she has chosen enhanced protection,* she is allowed to use all £3m to provide benefits without any lifetime allowance charge.

Enhanced protection is also available if your fund at 5 April 2006 was less than the lifetime allowance. In practice, it may be hard to see why anyone would initially choose primary protection, but remember that enhanced protection is only an option if you accrue no further benefits from your pension arrangements from A-Day. For money purchase arrangements, this means no further contributions and for final salary schemes it means no further pensionable service, although some increases in respect of salary/price inflation are permitted.

Who is able to retire early?

The minimum retirement age will rise to 55 in April 2010. However, you still have the right to earlier retirement if:

- You are an occupational scheme member who has a contractual right to retire before age 55 that was in existence before 10 December 2003.
- You are a member of statutory schemes (eg civil servant) and were given a contractual right to retire before 55 at any time before 6 April 2006.
- You joined an occupational pension scheme between 10 December 2003 and 5 April 2006, and it was normal practice before 10 December 2003 for employees in the scheme to be able to retire before 55.
- As at 5 April 2006 you were a member of a personal pension scheme or retirement annuity with a low retirement age (eg sportsperson).
- However, early retirement (ie retirement before 50/55) will only apply in respect of existing benefits, and will be subject to certain conditions, including a proportionate reduction in the amount of lifetime allowance available.

There is no transitional relief for ordinary investors in personal pensions (including stakeholder pensions), which previously always permitted retirement from age 50 onwards.

What happens if the tax-free cash sum exceeds the new limits?

The transitional reliefs for the tax-free cash sum are among the most complicated.

Assume that on A-Day you had accrued a tax-free lump sum benefit of more than 25% of the value of your benefits. If your tax-free cash entitlement at A-Day was not more than £375,000 and you have not elected enhanced or primary protection, at the time when you draw your benefits the pension scheme will be able to provide you with:

- The lump sum accrued *before* A-Day increased in line with the increase in the standard lifetime allowance,
- *Plus* 25% of the fund deemed to have accrued *after* A-Day where additional contributions have been paid to a pre A-Day arrangement. The deemed amount is calculated as the total fund when benefits are drawn, less the A-Day fund increased in line with the lifetime allowance. This situation will only apply to occupational schemes and buy-out (s32) policies (which could

not accept further contributions before A-Day). If returns are low, then the deemed amount may be nil. Other pension arrangements, with the exception of a limited number of retirement annuities, could not provide more than 25% of the fund before A-Day.

Example 7: Protecting tax-free cash – more than 25% of fund

On 5 April 2006, Jeremy had an executive pension plan with a fund of £300,000, of which his lump sum cash entitlement was £100,000. He retires in June 2010, by which time the lifetime limit has risen by 20% and his total fund is £500,000, thanks to additional contributions. Jeremy's tax-free cash would be calculated as:

Pre A-Day rights: £100,000 x 120%	= £120,000
Post A-Day rights: (£500,000 – [£300,000 x 120%]) @ 25%	= £ 35,000
Total tax-free cash	**= £155,000**

Where you have opted for protection and your tax-free cash entitlement at A-Day exceeds £375,000, then tax-free cash is also protected. The method used depends on which form of lifetime limit protection you choose. As a general rule the result is:

- *Primary protection* The pre A-Day lump sum is adjusted in line with the increase in the lifetime allowance.
- *Enhanced protection* The maximum lump sum is the same percentage of the capital value of your pension rights at retirement as it was at 5 April 2006.

Example 8: Protecting tax-free cash – more than 25% of lifetime limit

On 5 April 2006, Arabella had an executive pension plan with a fund of £1.6m, on which her lump sum cash entitlement was £480,000 (ie 30%). She retires seven years later, when the plan's fund has grown to £2.4m and the standard lifetime allowance has risen by 27%. Arabella's tax-free cash is calculated as:

- *If she had chosen primary protection:*

  £480,000 x 127% = £609,600

- *If she had chosen enhanced protection:*

  £2,400,000 x 30% = £720,000

Investment

Pre A-Day investments in SSASs and SIPPs are subject to transitional protection. This means that investments can remain in a SSAS or SIPP, even if they are outside the rules of the new regime. However, if there were to be an investment change now, for example in the terms of a loan made by a scheme before A-Day, the investment would become subject to the new rules.

Unapproved schemes

If you are a member of a FURBS and have been taxed on your employer's contributions, then the lump sum benefit accrued before A-Day is protected. The lump sum available at 5 April 2006 will be increased in line with the RPI to the date that benefits are drawn. The IHT benefits are also protected in respect of pre A-Day funds. However, 40% tax on investment income (32.5% on dividends) now applies.

ACTION POINTS

Many aspects of retirement planning need to be reviewed in the light of the changes introduced by pension simplification.

One difficulty is that many pension schemes are unlikely to allow their members to take advantage of all of the options permitted by HMRC's reform. For example, in some money purchase arrangements an unsecured pension might not be available and final salary occupational schemes might not be prepared to offer 25% tax-free cash.

Funds under lifetime allowance

- *Is investment within pension plans the right retirement planning strategy for you now?* The annual allowance makes it possible to delay the start of pension contributions until much nearer retirement than previously possible. This is especially so because there is no annual allowance ceiling for a scheme in the final year before drawing pension benefits in full from that scheme.

  Some experts have suggested that the right strategy now is to use other savings vehicles initially – such as individual savings accounts (ISAs) – and then apply their value as fund contributions when retirement nears. This approach provides greater flexibility because the funds will not be locked in a pension plan until a later date. However, outside an ISA, the strategy might be less tax-efficient and runs the risk that future changes in legislation or personal circumstances could limit the scope for last minute contributions.

- *How should you top up the retirement benefits from your employer's pension scheme?* It now makes no difference how you decide to top up your retirement benefits, because the same tax rules apply to all pension arrangements. However, in practice not all top up arrangements offer the full flexibility that the new rules make possible. For example, in-house AVCs are unlikely to incorporate an unsecured pension option.

- *Should you change your pension investment strategy?* The new investment rules may allow you to change the investment structure of your fund, for example, by selling personally owned commercial property to your pension scheme. In contrast, you might prefer to sacrifice potential investment growth in return for lower risk if your pension fund is close to the lifetime allowance, in order to avoid the lifetime allowance charge.
- *If your fund is close to the lifetime allowance, should you opt for enhanced protection if you still have the opportunity?* Enhanced protection would mean that if your fund grew to over the lifetime allowance, you would not suffer any lifetime allowance charge. However, it would also mean that you ceased active membership of all schemes with effect from 5 April 2006. This is not irreversible: you can revoke the enhanced protection option at any time before age 75.
- *Do you need to fill an income gap before age 55?* If you want to retire before age 55, but this would be after 5 April 2010, you could not look to your pension arrangements to provide you with an immediate replacement income without transitional protection. You might therefore need another retirement investment to bridge the gap before you could draw on your pension plans.
- *How should you draw retirement benefits?* Just because you are now able to draw 25% of your fund as a tax-free lump sum does not mean that you should automatically do so. At present, the factors used by many final salary schemes to convert pension to cash fail to reflect the pension’s true value. Strange though it may seem, a taxed pension can sometimes be better value than a tax-free lump sum.
- *Does your life assurance cover need review?* The new rules for pension life cover mean that it may be possible to replace your existing life cover (eg for family or mortgage protection) with pension term assurance, thereby gaining full income tax relief on your premiums. Alternatively you may be able to increase your level of cover substantially while maintaining the same net outlay.

Funds over lifetime allowance

There are some difficult choices to be made if the total value of your pension funds at 5 April 2006 was over the lifetime allowance.

- *What transitional protection should you opt for?* Within three years of A-Day you must register your funds with HMRC and opt for primary protection and/or enhanced protection. Enhanced protection is the obvious first choice. It protects all your funds from a lifetime allowance charge and still leaves you the option to apply primary protection later (provided you elected for both options), if you wanted contributions to be resumed, for example because of a fall in fund values when you near retirement.

- *What should you do about any funded unapproved schemes (FURBS)?* From 6 April 2006 the tax rate on income within FURBS rose (the rate of tax on gains had already increased) so you should review the plan's investment approach. It could make sense either to restructure the FURBS investment holdings or possibly withdraw funds and invest them personally.
- *How should you and/or your employer fund for your retirement?* Employer contributions to FURBS are now less attractive than they were, because the employer does not benefit from immediate tax relief and all the benefits are taxable as income. You and your employer need to consider alternative remuneration strategies, for example share incentive schemes or simply increased pay that can fund tax-efficient personal investment, eg via venture capital trusts (although the tax relief on these was reduced to 30% from A-Day).

Employer considerations

If you are an employer and have pension arrangements for your employees, the pension tax reforms could have a major impact on this aspect of your remuneration structure.

- *How should you deal with those affected by the lifetime allowance?* Some of your most senior, and longest serving, employees are now in a position where it makes no sense for further pension contributions to be made on their behalf. This raises complicated issues of redesigning remuneration strategy, because shorter serving but equally senior employees may not be immediately affected by the lifetime allowance.
- *What should happen to pre A-Day pension arrangements?* The new tax rules raise awkward questions about how many changes should – or must – be made in the light of the tax reforms. In some instances, the reforms might prompt a total review of retirement provision. The sooner you start to think about the impact of the reforms, the better.
- *How should you communicate the changes to employees?* Many employees are largely unaffected by the reforms, particularly those who are members of group personal pension or stakeholder arrangements. Others are winners because they will be able to draw more tax-free cash. Some are losers, because their prospective tax-free cash will be reduced. The message of the changes needs to be communicated clearly and quickly – A-Day has now passed.

THE NEED FOR ADVICE

At the time of writing, the reforms described above are set out in the Finance Act 2004, Finance Act 2005, over 40 sets of final regulations and Finance (No 2) Bill 2006. Parts of the structure may still change before the Bill becomes the Finance Act 2006. This possibility, and the complexities of transition from eight pension regimes to one, mean that you should get advice before taking any action. As A-Day is now behind us and some opportunities have possibly already been lost, advice is best obtained as soon as possible.

This guide is for general information only and is not intended to be advice to any specific person. You are recommended to seek competent professional advice before taking or refraining from taking action on the basis of the contents of this publication. The guide represents our understanding of the law and HM Revenue & Customs practice as at June 2006, which are subject to change.

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