

PENSIONS SHAKE-UP - GOOD OR BAD NEWS?

A summary of the Government's proposed revision of pensions legislation

Government proposals to shake-up pensions look certain to make 2011 a year of change and opportunity. From next April, pension scheme members can expect to see some fairly radical developments as the Government revises the rules on contributions and retirement benefits. While the changes are to be welcomed on the whole, there will be winners and losers. The next few months will certainly be a busy time for many pension scheme members as they look to discuss the changes with their adviser.

The following summary of the proposed changes gives an indication of what lies ahead. As always Brown Shipley will be contacting clients personally to discuss individual circumstances. However, please call us to discuss - we are always ready to talk.

Summary of the main changes

From 6 April 2011

New limits on pension contributions

- The maximum annual contribution limit is reduced to £50,000 per annum.
- Unused allowances from the previous three years can be carried forward, in some circumstances.
- Full tax relief available at marginal rate - up to 50%.

Retirement and death benefits

- New income limits and rules for anyone in income drawdown.
- Option to defer tax-free lump sum beyond age 75.
- No requirement to purchase an annuity at any age.
- Change to the taxation of lump sums paid on death.

From 6 April 2012

Lifetime allowance

- The maximum limit placed on pension savings is reduced to £1.5m - this is known as the Lifetime Allowance.
- Those with larger pension funds can "lock-in" at the existing limit of £1.8m.

Protected rights

- Removal of the special rules for protected rights, which will effectively be merged with other benefits.

What is changing from 6 April 2011?

Limits on pension contributions

- The annual allowance will reduce to £50,000 (from £255,000 for the 2010/11 tax year).
- The current anti forestalling measures for high earners will cease.
- Full tax relief available at marginal rate - up to 50%.
- Introduction of three year carry-forward of unused allowances from previous years.

Retirement and death benefits

- Removal of requirement to purchase an annuity by age 75. Brown Shipley's pension products already allow deferment beyond age 75.
- Tax-free cash can now be taken after age 75, providing members with enhanced flexibility.

Income drawdown

- Existing rules for income drawdown will be abolished. Clients in Unsecured Pension (USP) and Alternatively Secured Pension (ASP) will move into "capped drawdown". This will provide an annual income between nil and 100% of comparable single life annuity, based on actual age.
- Capped drawdown is likely to represent a reduction for USP clients where maximum income is currently higher, at 120%. However, it should be an improvement for clients with ASP as there is no longer any requirement to draw an income between 55% and 90% each year and it will be based on actual age rather than the current age cap of 75.
- Income limits will be reviewed every three years and annually after age 75. However, the first review under capped drawdown will take effect from 6 April 2011 at the earliest, and possibly much later for some clients:
 - † For existing USP clients the new limits are normally applied from the 5th anniversary of the most recent review falling on or after 6 April 2011.
 - † For ASP clients, and any USP clients who reached age 75 on or after 22 June 2010, the new limits are applied from the start of the 1st pension year falling on or after 6 April 2011.

Brown Shipley Comment

The move to the new income limits will be a mixed bag for clients. For those currently in USP, it may be necessary to reduce their income when they move to the new basis, particularly where they are drawing the maximum already. In contrast to this, anyone in ASP will be able to take advantage of more flexible income limits, perhaps taking nothing at all.

In limited situations it may be possible for USP clients to arrange a new review before 6 April 2011. This would have the effect of pushing back the 5th anniversary, possibly to 2016. Similarly, any clients who were considering drawing benefits after 6 April 2011 may well be better off by taking action now.

As a final point to note, one quirk of the new rules is that transferring benefits to a new pension scheme after 6 April 2011 will automatically create an income review on the new basis.

- For some clients, there will be an additional option of “flexible drawdown” although taxation will be a major consideration in any planning:
 - † A new facility to drawdown funds without limit and subject to normal income tax rules.
 - † This option is only available where individuals have a source of secured income (other pension and/or state benefits) and meet the annual ‘Minimum Income Requirement’ of £20,000.
 This is perhaps one of the more radical developments and will require careful analysis, particularly in view of any potential tax consequences.

Brown Shipley Comment

At first glance the concept of flexible drawdown may seem quite attractive. The outcome may lead to some less desirable results.

Let us consider a client who satisfies the secured income requirement and decides to withdraw the full value of their pension fund. Firstly, the fund will be taxed as income tax, which could be as high as 50%. The client will then hold the funds personally and will need to make their own decisions about tax-efficient investments. In the event of death, the funds could be subject to IHT at 40% making an effective tax rate of 70%, if we assume that the initial income tax charge was 50%. If the client had left the money in their pension fund until death, it could have been paid as a lump sum less tax of 55%.

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Death benefit lump sum to beneficiaries

- Death before age 75:
 - † Fixed rate tax charge increased to 55% (from 35%) for crystallised funds.
 - † Uncrystallised funds continue to be paid free of tax.
- Death on or after age 75:
 - † New option to pay fund as a lump sum less tax charge of 55% (previously lump sum was taxed as an unauthorised benefit at an effective tax rate of up to 82%).

Brown Shipley Comment

In the short term, the new tax rate of 55% on the death benefit lump sum will be an unwelcome development for many income drawdown clients. However, this needs to be balanced with the increased flexibility from age 75 and the certainty that their fund can be passed on to their family or beneficiaries as a lump sum, subject to tax of 55% and no IHT. This is a significant improvement on the current rules.

As there will no longer be a requirement to draw a minimum income post age 75, and with no IHT charged on the fund, the facility to pay the pension fund as a lump sum on death post age 75 may well introduce some new estate planning opportunities.

Inheritance tax on death benefits

- IHT will only be payable where the member has nominated their estate or they have control over the payment of death benefits (normally the trustees will have discretion).
- IHT anti-avoidance measures are currently incurred when a member fails to draw benefits whilst in ill health. Under the proposals these charges will be removed. This measure taken with the new death benefit lump sum rules post age 75, may well introduce some new estate planning opportunities.

What is changing from 6 April 2012?

Lifetime allowance

- The lifetime allowance ('LTA') will reduce from its current level of £1.8m to £1.5m.
- Anyone with significant pension savings can register for 'fixed protection' and retain an LTA of £1.8m for when they crystallise benefits.
- Registration must take place before 6 April 2012.
- Contributions cannot be paid after registration or the fixed protection will be lost.
- Individuals who previously registered for enhanced and/or primary protection will not be eligible.

Brown Shipley Comment

2011 will be a key year for clients who have a pension fund approaching £1.5m, and particularly those who would like to make some significant contributions.

While many high earners will have been limited to annual contributions of no more than £20,000 in recent years, this restriction will be lifted in the new tax year at which time they can also carry forward any unused allowance from previous years too. However, as it will not be possible to make contributions after registering for "fixed protection", there will be a short period of time in which to decide on the best way forward, bearing in mind the closing date of 5 April 2012 to register for protection.

The carry-forward rules are to be welcomed and will provide clients with a limited window of opportunity to address any contribution deficit from previous years, perhaps when they were financially unable to maximise their contributions. In the most extreme cases, it will be possible to make an annual contribution of £50,000 and then carry-forward unused allowances of £150,000 from the previous three years.

Protected rights

- The special rules governing how protected rights should be treated will be removed. These funds may then be fully merged with other benefits.
- There will no longer be any requirement to provide a spouse's pension on death.
- Any death benefit lump sum payment will not be subject to IHT.

What next?

This information is based on our understanding of Government proposals likely to be included in the Finance Bill 2011. The information contained in this publication does not constitute advice. In all cases individuals should seek professional advice before taking any action. If you would like to find out more please don't hesitate to contact us.

The value of investments and the income from them, may fall as well as rise, and you may not recover the amount of your original investment. The tax reliefs referred to in this guide are those available under current legislation, which may change, and their availability and value depend on individual circumstances.

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