

## Pension Planning: The New Tax Regime 2011/12

The subject of Pensions tends to be one which many of us prefer to put off (if not ignore), whether on the basis that retirement feels simply too far ahead or because there are already enough calls on net income to worry about making pension contributions. However, it is well worth understanding the basic framework set out in the legislation, so that at least any decisions can be taken on the basis of 'best information'.

The stimulus to individual pension saving is provided not only by the relatively low level of the State pension. Specific encouragements are given in the form of reliefs from Income Tax for qualifying contributions and the fact that income and gains within the pension fund will accrue free of tax (although there is no ability for the pension fund to recover the non-repayable 10% tax credit on dividends).

The basic principle of funding a pension derives from the benefits of 'compounding'. That is, the earlier in life that funds are contributed (and it is hoped start to grow within a tax-favoured environment), the greater the future benefit. It is fairly obvious that at say age 65 contributions of £500 a month begun at age 30 will be worth very substantially more than similar contributions begun only at age 50.

A radical change took place on 6 April 2006 ('A Day') under the last Government. Expressed to be a simplifying reform, one might not think so, especially when trying to comprehend the effect of the numerous changes which have taken place since. However, for purposes of this Briefing, anything before tax year 2011/12 might now be regarded as 'ancient history'. This is because, following a consultation put in place last Summer, the Coalition Government has introduced what is now the current regime which might be reasonably expected to stay in place, at least during the lifetime of this Parliament.

In broad terms, one needs to appreciate:

- the limits on what can be contributed to a pension scheme each year, with the benefit of tax relief;
- in what 'permissible assets' the pension funds can be invested; and
- what are the available options in terms of drawing on the pension fund in due course.

### **Contributions: The two basic controls**

#### ***The annual allowance***

Everyone aged under 75 has an annual allowance of the higher of '*relevant UK earnings*' and £50,000 for 2011/12. If contributions exceed the permitted maximum, any tax relief given on the excess in the self assessment is balanced by what is called an '*annual allowance charge*' at the relevant marginal tax rate of 40% or 50%. That said, however, employees can suffer an unwelcome tax charge where the excess contributions have been made by their employer.

There is incidentally a basic entitlement for anybody to contribute £3,600 gross to a pension scheme, regardless of pensionable earnings. So a net contribution of £2,880 will have £720 added by the Government (by way of 20% tax relief). In other words, that is something which an earner could do for a non-working spouse or indeed for children or grandchildren, although the latter would be gifts for Inheritance Tax (IHT) purposes, subject to the lifetime exemptions.

We also now have the ability to carry forward any unused contributions for the three previous tax years (up to the annual allowance each year), provided that the individual was then a

member of a pension scheme. This facility has been introduced for the first time from 2010/11 and is really rather generous, certainly when compared to the transitional provisions which were in place for the two to three years before then, especially for anyone with earned income over £130,000.

Assume for purposes of the following illustration that the taxpayer has UK earnings of more than £50,000. To take advantage of the carry forward provisions for 2011/12, more than £50,000 must be contributed, so in principle attracting the 'annual allowance charge'. One then looks back at tax years 2008/09, 2009/10 and 2010/11 (assuming that the individual then belonged to a pension scheme), to see to what extent in any of those years contributions of less than £50,000 were made (even though that was not then the relevant limit). Any unused balance is available for carry forward to 2011/12 and will secure Income Tax relief at the marginal rate, ie up to 50%. So in an extreme case £200,000 of contributions could be made in 2011/12 at an effective net cost of £100,000 – assuming always that the fund remains within the 'standard lifetime allowance' on a 'benefit crystallisation event', both mentioned below.

### **Example**

*Alison has UK relevant earnings of £200,000 for 2011/12 and makes a pension contribution of £100,000. In principle she will suffer an annual allowance charge on £50,000. However, in 2008/09, 2009/10 and 2010/11 she made contributions of £20,000, £60,000 and £10,000 respectively. So she has unused relief of £60,000 (£50,000 x 3 less £90,000). £40,000 is available to carry forward from 2010/11 and £10,000 from 2008/09, so avoiding the annual allowance charge. However, the remaining balance of £10,000 from 2008/09 (after deducting the surplus £10,000 from 2009/10) is effectively wasted after 2011/12.*

There are two further cautions:

- The annual allowance is based not primarily on tax years, but on 'pension input periods'. While for most people this will be the tax year, for a few it may not be and would be the anniversary of starting the scheme. So someone who joins a pension scheme on 1 October 2011 and makes a contribution on 1 November 2011 will find it referred to tax year 2012/13, in which the first pension input period ends, not 2011/12. To rectify the position, the first pension input period should be ended early on 5 April 2012.
- There are strong current rumours that the top rate of pensions tax relief might be reduced to 40% in Budget 2012. If this happens, it would be seen to have been sensible to make as full use as possible of the current 50% relief where available.

In cases where the individual is employed, contributions may be made by the employer as an alternative or even in addition to contributions by the individual. The advantage of the former is that there will be a saving in National Insurance, which is not the case where the contribution is made by the individual. In any event, the limits apply to total contributions each year, whether made by the employer or by the individual employee.

### **The standard lifetime allowance**

This is the second basic control to which tax relief on pension funds may be subject. For 2011/12 the allowance is £1.8 million, though it is set to reduce to £1.5 million in 2012/13 – the level at which it was first introduced in 2006/07. The standard lifetime allowance is tested against the pension fund on one of eight 'benefit crystallisation events (BCE's)', for example on the withdrawal of funds or the attaining of age 75. If a penalty tax charge arises, tax may be levied at up to 62.5% in total, though the tax payable depends on how the funds are applied and could be rather below this.

There were before 'A Day' those whose pension funds were worth more than the then limit of £1.5 million and could therefore have applied before 6 April 2009 for so-called 'enhanced' or 'primary' protection. This gave them the benefit of a higher lifetime limit on condition that they made no further contributions. Now there is a mechanism in place to protect those who will be adversely affected by the reduction in lifetime allowance on 6 April 2012. They can apply for 'fixed protection', although the election must be submitted before 6 April 2012. Indeed there may be cases where it is sensible to elect, even where the pension fund is below £1.5 million, depending upon age and all the circumstances.

Given that no further contributions can be made, then, in broad terms, the excess over £1.5 million (within the current £1.8 million) is treated as protected. Assume the value at 5 April 2012 is £1.75 million, that is 16.67% in excess of £1.5 million; this uplift will be applied to any

future increases in the lifetime limit. So if the limit were increased to say £2 million, the protected limit for that individual would become £2,334,000.

### **Permissible Assets**

A personal pension might be either a '*self-invested personal pension*' (SIPP) or a '*small self-administered scheme*' (SSAS). There are distinctions between these two arrangements, though for all practical purposes they can be regarded as the same, except that:

- whereas there is no limit on the number of members for a SIPP, a SSAS must have less than 20 members, typically belonging to the same family or maybe those employed by the one small company;
- while a SIPP cannot lend back to the company, a SSAS can; and
- while a SIPP can hold as many unquoted shares as it chooses, a SSAS cannot hold more than 5% of the shares in a company connected with a member of the scheme (rising to 20% where the SSAS has four or more relevant employers)

Neither scheme can invest in '*prohibited assets*', which broadly embrace:

- residential property, subject to some exceptions eg an hotel or a pub; and
- '*tangible movable property*', meaning things like fine wines, classic cars, art, antiques and indeed any property costing more than £6,000.

There can be a nasty trap insofar as the pension-holder is a '*controlling director*' (that is, one who owns more than 20% of the voting share capital or, with his associates, more than 50%). The prohibition extends to property owned by the company. In that case, investments such as buy-to-let property or indeed company cars, office furniture or computer equipment would trigger what can be punitive tax charges on both the pension fund and the scheme administrator.

### **Proactive structuring**

Where the individual owns shares in the family company, there can be significant benefits in adopting a structure whereby all of or a share in the property from which the company operates is owned by one or more pension funds. That is, subject to the limitations presented by the annual allowance and the lifetime allowance, tax-deductible contributions could be made to the fund(s) which acquire(s) the property and then rent(s) it back to the company for full value. The rent paid by the company is deductible for Corporation Tax purposes and accrues tax-free in the pension fund(s).

There are limits on the amount which a SIPP can borrow to finance the acquisition of property, viz 50% of net assets – and of course it is never a good idea to put all one's eggs in one basket. Indeed, HMRC's Registered Pension Schemes Manual states that trustees must act '*prudently, conscientiously and honestly when making decisions in respect of the schemes. Trustees should at all times act in the best interest of scheme members in their capacity as trustees and not as employees, shareholders etc*'.

### **Example**

*In 2011/12 Adam's pension fund has assets of £1 million, invested in a variety of managed funds, property funds and stock exchange investments. With relevant earnings of £250,000 he has carry forward relief from the three previous tax years totalling £50,000 and so plans to contribute £100,000 in the current year. His business colleague Eve is in a similar position. The company which they own and through which they trade wants to finance the acquisition of a new building and improvement expenditure totalling £2 million.*

*Neither Adam nor Eve, in their mid-forties, is keen to put more than half their respective funds into the property, though they and the trustees are prepared to borrow, with appropriate security. Of course, the borrowing could be done by the company so as to acquire a half share in the property. However, the advantage of the acquisition and the borrowing being made by the pension funds is that any capital growth would accrue to the two pension funds free of tax. And any gains on realising investments within the funds would also be tax-free. So each fund puts forward cash of £500,000 and borrows £500,000 to acquire and develop the property which is then let to the company. The company pays a market rent each year, as a deductible expense from profits, and the rent is used to offset the interest costs and otherwise grows tax-free in the two pension funds.*

### **Withdrawing the benefits**

With exceptions for certain occupations (eg bond dealers and National Hunt jockeys), pension income cannot be drawn while under the age of 55. And, now, there is no maximum age above which benefits must be drawn. So, while somewhat improbable, an individual could reach age 75 and having enough to live on from other sources choose not to draw anything from his pension fund until subsequently dying at a ripe old age - although there would be a tax charge at that point, as explained below.

### ***Drawing the 25% tax-free lump sum***

There is the traditional and attractive facility to draw up to 25% of the fund tax-free, whether or not one then takes an income from the fund. However, the problem is that if that happens before age 75, then even if the death benefits have been written under trust so as to pass free of IHT, there will be a Scheme tax charge at 55% on what is left in the fund at that stage (after providing for a surviving spouse/civil partner or financial dependants or indeed charity). Having said that, it is possible to divide the pension fund into two, a '*crystallised*' and an '*uncrystallised*' amount, so that any drawings of income are taken from the former, leaving the latter to grow, so that in the event of death before age 75 the uncrystallised fund can still be paid to the family free of all taxes. Where death occurs at or over age 75, a Scheme tax charge will be levied, even on an uncrystallised fund.

To achieve this, the individual must be able to demonstrate an annual pension income of not less than £20,000 from '*secure sources*', that is whether state pension, annuity or final salary scheme income.

### ***What to do about pension income?***

It may well be that an individual will need the pension fund to provide an income for the remainder of his/her lifetime. In this case careful advice will be needed on the investment of the fund, given likely income requirements in the light of any other resources available. If on death there is a surviving spouse/civil partner or financial dependant, then within limits a balance in the pension fund can be used to provide pension income for them. And any balance remaining after all the deaths can be paid under a trust to for example children, subject to a Scheme tax charge of 55%. Incidentally, this Scheme tax charge is avoided for any payment going to charity. For someone who is charitably minded and plans to make a significant charitable gift under the Will with IHT relief at 40%, it could be worth making such provision instead from a pension fund, ie saving Income Tax at 55% rather than from the free estate with an IHT saving of just 40%.

However, it may be that on account of other financial resources in the family, all or part of the pension fund can be regarded as '*surplus to requirements*'. The decision then becomes whether in principle income should be maximised or minimised in retirement. This is of course subject to the testing of the pension fund on any BCE. In broad terms the choice is between (a) maximising income with Income Tax payable at up to 50% (though only 40% where taxable income after the personal allowance falls between £35,000 and £150,000); and (b) leaving the funds to grow, to become subject ultimately to a Scheme tax charge of 55%. One of the advantages of the former option is the immediate use of the net cash insofar as surplus to spending requirements.

First, for example, gifts could be made as part of a regular pattern free of IHT under the normal expenditure out of income exemption. Second, pension contributions could be made for children or grandchildren of up to £3,600, ie £2,880 each net of basic rate Income Tax as suggested above. Or indeed, third, annual amounts could be paid to children who have their own relevant UK earnings but are not making sufficient contributions themselves. As a fourth suggestion, all or part of the tax-free lump sum could be used to buy an annuity, only part of which attracts Income Tax, the balance being treated as a return of capital. The individual could use the after-tax income to pay annual premiums on a policy on sole or joint lives written in trust for the children. Care has to be taken that the purchase of the annuity and the setting up of the life policy are not '*associated operations*' for IHT purposes. That is, the policy must be issued on full medical evidence and can be proved to have been issued on those terms in the absence of the annuity.

### ***Deferring the normal retirement date***

The age of 75 remains relevant in that on death under that age funds can pass to the family free of all taxes from an '*uncrystallised fund*' (which could be the whole pension pot), from which no drawings have been made. In very many cases of course, one's financial position will be such that drawing on the pension fund will start long before age 75 is reached. There was in 2010 a First-tier Tax Tribunal decision in a case called *Fryer*, involving one Mrs Arnold who having reached her normal retirement date of 60 (knowing she was terminally ill) chose

not to draw a pension and sadly died from the cancer within a year. Because she could have drawn her pension at age 60, she had in the statutory language '*omitted to exercise a right*' and was therefore treated as having made a chargeable transfer of her pension fund for IHT purposes immediately before she died. That case still has application where death occurs from illness as opposed to accident and the pension funds pass other than broadly to provide for a surviving spouse/civil partner or financial dependants or charity. To avoid the possible application of the decision, it should be easy enough to extend the normal retirement date to 75, on the footing that an application could be made to the trustees to pay monies (income or capital) earlier than that on need.

On choosing to draw pension income, whether before or after age 75, there is no minimum. There is a maximum after age 75 which is called '*capped drawdown*'. This is 100% of present single life annuity rates (fixed by the Government's Actuarial Department (GAD) tables by reference to the current long term gilt yield). This maximum amount will be subject to change as one gets older. There is a review of income drawn every five years (each year after age 75), so one needs to be aware of the danger of the funds becoming severely depleted before death occurs.

### **The foreign element**

The legislative framework and the tax reliefs proceed generally on the assumption that the pension fund is a UK registered scheme. In certain cases a UK scheme can make a transfer to what is called a 'Qualifying Recognised Overseas Pension Scheme' (QROPS) without a Scheme sanction charge. To be a QROPS depends upon satisfying Her Majesty's Revenue and Customs that it qualifies. Especially if the individual is thinking of moving abroad, this could prove quite tax and investment efficient. That said, a new provision in this year's Finance Act has been enacted '*to prevent tax avoidance through the interaction of relief for pension savings and the provisions of certain double tax arrangements*'. The rules were introduced to close a loophole in the double tax agreement between the UK and Hong Kong under which a UK resident taxpayer could receive income from a Hong Kong QROPS at a top rate of 17% on income, with tax-free treatment for lump sum payments.

### **Conclusion**

Pensions are a hugely complex subject, but we hope that this very brief overview will have given you food for thought. We would be happy to discuss with you further any of the suggestions made in this Briefing and indeed if appropriate to introduce you to an appropriate pensions consultant.

For further information please contact Danny Clifford on 01473 220083 or email [danny.clifford@ensors.co.uk](mailto:danny.clifford@ensors.co.uk)

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