

Pension Schemes Tax Simplification – Latest Developments

The long-anticipated changes to the pensions tax regime came into force on 6 April 2006. These reforms had been in development since early 2002, so naturally there were still many areas of uncertainty in April! Many aspects were not clarified until the Finance Act 2006, which was published in July, several months after the regime began to apply! There remain some issues of great uncertainty. We have received yet more "clarification" with the Chancellor of the Exchequer's Pre-Budget Report on 6 December. This newsletter covers some of the areas of greatest interest to small scheme members, and some of the latest developments in retirement planning which involve these "Do It Yourself" arrangements.

Pensions After 75

One of the most popular features of the tax reforms was the removal of the requirement for the purchase of an insured annuity before the member's 75th birthday. Whilst annuities remain the only way to guarantee pension income, they were not popular with SSAS or SIPP members, because of the perception of poor value for money, and the loss of capital on death. However, the Government confirmed in a recent consultation document on "The Annuities Market" that it remained convinced that annuities were its favoured approach for pension payments. Following the reforms, the most likely choice for many members reaching 75 was likely to be "Alternatively Secured Pension" (ASP). The Pre-Budget Report introduces major, mostly unhelpful, changes, and from 6 April 2007, ASP will work as set out below.

Alternatively Secured Pension (ASP)

- The member's fund remains invested, and his pension is drawn down directly from the Scheme.
- The net value of the member's own fund share is used to calculate a maximum pension.
- This maximum is calculated using tables from the Government Actuary's Department (GAD) and is limited to 90% of the annuity to a 75 year old, regardless of his actual age (previously the maximum was 70%).

- The member must draw a minimum pension of 65% of the annuity to a 75 year old, regardless of his actual age (there was previously no minimum).
- The pension is reviewed annually, but because of the two artificial restrictions, is likely to remain lower than the pension from an insured annuity. The gap will increase with the member's age.
- On the member's death, the residual fund must first be used to provide a dependant's pension.
- On the later death, the residual fund may be reallocated to other members. For SIPPs, this would require other family members to join as "sleepers", with nominal funds attached to the member's own SIPP. This reallocation is to be taxed as an unauthorised payment. This tax, effectively 55%, could be even higher, since if the payment is more than 25% of the fund, the Scheme would pay a further 15% "Unauthorised payment surcharge". It might also suffer 40% tax on its assets and lose its "registration" (the tax exempt status). The total tax on the pension fund could be as high as 89.2% if the residual fund is then subject to inheritance tax on the original member's estate! (It remains to be seen precisely how this will work).
- Despite this, the surviving members might still receive some of the deceased member's fund: still more wealth than is preserved on death where the pension comes from an insured annuity.

The changes follow HM Treasury's recently stated opinion that ASP was only ever intended for those with a principled religious objection to insured annuities, and that they would legislate if they felt it was being used for tax avoidance. There could be, however, nothing in the legislation or guidance to restrict the use of ASP on these grounds, as it would constitute religious discrimination. In realising this, the response from Government has been to try to tax ASP out of existence, and effectively force SSAS and SIPP members to use their funds for insured annuities.

An alternative to ASP, which could be used by SSAS, is Scheme Pension. This still pays a pension direct from the Scheme, but with less flexibility than ASP. Unfortunately, the Pre-Budget Report tells us that the Scheme Pension rules, too, will be amended to prevent them being used to reallocate pension funds to other members on death. This will prove a difficult area to legislate, because Scheme Pension is the method by which pensions are paid to members of large defined benefit schemes. Those schemes rely on cross subsidy from members who die early for part of their funding.

The tax bill is likely to discourage all but the most keen annuity avoider from using ASP. If passed, this legislation would be a bizarre end to a reform which was introduced by this self same government only eight months ago, and to which nobody objected! In fact, the tax take for the Treasury from ASP would have been greater than it is from annuities. This suggests an old fashioned attempt to "soak the rich", rather than a reform to prevent tax abuse. In response to the announcement, Adrian Waddingham wrote this letter to the Financial Times, which was published on Thursday 8th December.

Sir,

The Chancellor's Pre-Budget Report seeks to impose new taxes on pension savings for those who have the temerity to survive beyond age 75. Any remaining pension savings on death after that age are to be deemed "unauthorised payments" and taxed at the penal rate of 70%. This early U-turn on the April 2006 pensions tax rules is not consistent with the government's objective to encourage retirement savings. Nor does the imposition of an age-related tax fit their stated desire to outlaw age discrimination. The Treasury will find themselves fighting hard to maintain this absurd suggestion.

Yours Faithfully, Adrian Waddingham

Senior Partner, Barnett Waddingham LLP

Despite this, trustees might still use ASP. On the death of the dependant, the trustees might pay the remaining fund out of the Scheme (since it will now be taxed similarly to reallocating within the Scheme) and the recipient would still receive more after tax than they would have done from an annuity, where the amount passed on is usually zero. If they then make a contribution of these funds to a registered pension scheme, they will be entitled to tax relief, which would offset some of the tax paid on the death benefit.

Pensions Before Age 75

Where SSAS and SSIP members draw pensions directly from the scheme before reaching age 75, the Finance Act 2006 provides that a maximum pension is set at the time of retirement, which is re-set only after five years, or earlier if a new element of pension is crystallised. This was a little inflexible, and the Pre-Budget Report indicates that after 6 April 2007, the member will be able to request a more frequent calculation for a new maximum. This would allow reviews of pension as often as annually, if the member requests it, but the Scheme Administrator and Trustees will not be able to demand a more frequent review.

Life Cover Only Arrangements

The Pre-Budget Report includes gloomy news for providers of pension related life cover. The Finance Act 2004 currently allows standalone pension arrangements which provide only life cover to be operated. This has long been part of the pensions landscape: before the Finance Act, both personal and occupational pension schemes were commonly established to provide life cover only. However, according to the Treasury, this undermines the principles behind the tax relief available under the pensions regime. It is likely that these useful arrangements will no longer be permitted after 6 April 2007. This will cause difficulties for those clients who had established arrangements under the new regime, although we are promised that Government will not interfere with arrangements which pre-date the Pre-Budget Report.

What are the new limits on company contributions?

In theory the new tax laws permit a company to make contributions up to £215,000 each year. However this does not mean the company will get corporation tax relief on the whole contribution. Revenue guidance says that the amount of the contribution must still be justified as "wholly and exclusively for the purposes of the business" which we broadly interpret as being a normal business expense. It is too soon yet to see how local Inspectors of Taxes are interpreting this – perhaps we will be back to justifying contributions with regard to salary and service! Please check with your usual Barnett Waddingham LLP consultant before making contributions for a member in excess of his salary.

Lump Sum Death Benefits and Inheritance Tax

The Finance Act 2006 finally included confirmation of how death benefits from SSAS and SIPP will be treated for inheritance tax (IHT) under the new regime. On the death of a member before he has drawn benefits, the whole of his pension fund (up to the Lifetime Allowance if he has not taken Enhanced Protection) may be paid to the nominated beneficiaries, free from IHT.

On death after benefits have been drawn, whilst taking "Unsecured Pension", most lump sums should escape IHT, but the rules provide for the tax to be imposed if, in the view of the Revenue, the member was deliberately drawing a low pension to avoid IHT. In any event, there is a special income tax charge of 35% levied on the pension scheme. If a member has switched on ("crystallised") only a part of his pension benefits, the lump sum benefits will be taxed only on the element representing Unsecured Pension, and not on the uncrystallised funds.

Taxable Property and Unquoted Shares

SIPP and SSAS are now both able to invest in unquoted shares. This was not the case for SIPP before 6 April. However, the Revenue see unquoted shares as a possible path to investing in "taxable property". Investment by pension schemes in such property is heavily taxed under the new regime. Unfortunately, the legislation is a blunt instrument, the definition of taxable property is wide, and any tangible asset might fall into the definition. Residential

property, holiday homes, cars, fine wines, jewellery etc are all caught. The requirements placed on trustees to avoid tax vary, depending on how "arm's length" the holding is. Where the shares are in a company "connected" to the member, the trustees need to make sure that the following conditions are met in respect of any potentially taxable property owned by the company

Connected Unquoted Shares

- If the company buys any tangible property, it should be worth less than £6,000.
- The Trustees must make sure that the property is used for the purposes of the business, rather than for the benefit of other parties, such as the directors of the company and their family.
- The onus will fall on the trustees to prove this, should the Revenue question the investment.

Sometimes, trustees may invest in shares in genuinely unconnected companies. The Revenue are anxious to police these investments, and typically will want to know whether the company will invest in residential property, perhaps in the form of a residential property syndicate. There are then some different points to check to ensure that the investment will escape the definition of "taxable property". It is important before buying that you confirm the following:

Unconnected Unquoted Shares

1. That the trustees are buying less than 10% of the company in question.
2. That the company has assets of at least £1m.
3. If the answer to point 2 is no, that there are at least three properties in the company's portfolio.
4. In either of these cases no asset held directly by the vehicle which is taxable property has a value which exceeds 40% of the total value of the assets held by the company.
5. That the company is not a "close company" – this means broadly that the company is not controlled by a closed group of five or fewer directors or shareholders (or if the company is not UK based, would not be a "close company" had it been UK based).
6. The company does not have as its purpose the holding of animals (i.e. a horseracing or greyhound syndicate).



The Regulation of SIPP's

The pensions tax reforms were originally framed to allow investment in a much wider range of assets, including residential property. At the time, fears of inexperienced operators using SIPP's to buy residential property led to a promise that providers of SIPP's would be subject to regulation under the Financial Services Act. The fears of unregulated providers running amok in pensions receded when residential property was effectively banned, however, the introduction of SIPP regulation remains. As a result, from 5th April 2007, SIPP's will have to observe similar rules to insured pension arrangements. In practice, there will be relatively little change as far as the SIPP member is concerned, although we will be writing to all our SIPP clients in the New Year to provide some further details.

SSAS and SIPP Properties – New Fire Regulations

New fire safety regulations in England Wales and Scotland came into force from 1st October. These will require SSAS and SIPP trustees who own property to ensure that they or their tenants carry out a fire risk assessment and act upon it. The assessment must:

- Focus specifically on fire risk to those at special risk.
- Consider any dangerous substance likely to be on the premises.
- Identify risks that can be removed or reduced.
- Help to establish how risk can be removed or reduced.
- Help to decide how to protect people against any remaining fire risks.

Barnett Waddingham LLP's Small Scheme Review

One of the more difficult aspects of the new pensions regime is for SSAS and SIPP members to estimate how their funds will perform in relation to the Lifetime Allowance (the limit on tax efficient pension monies which can be accumulated in your lifetime, namely £1.5m for the year to 5 April 2007). To assist members and trustees, Barnett Waddingham LLP has devised a comprehensive report which will help members to gauge how their funds will perform against the limit, allowing for contributions being made. It allows varied assumptions to be made, for example the anticipated investment returns and age at retirement. To give you a flavour of the report, a sample of one part of it appears as an insert with this newsletter. We expect the report to cost around £500 plus VAT for a two member scheme, with additional costs of around £120 plus VAT per extra member.

Please contact your usual Barnett Waddingham LLP consultant if you have any query.

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