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TAX
Pension Taxation

Pension taxation was supposedly simplified with effect from 6 April 2006 ('A-Day'). Unfortunately that simplicity has been marred by a welter of changes since (including some announced and legislated - but dropped even before implementation). The position from 6 April 2014 is summarised below, with a note on the changes proposed from 6 April 2015.

Lifetime limit and Annual limit

There is a lifetime limit on the amount of pension saving that can attract favourable tax treatment, complemented by an annual limit on tax-free inputs to an individual's pension arrangements.

The lifetime limit from 6 April 2012 until 5 April 2014 is £1.5m, but fell to £1.25m from 6 April 2014 until 5 April 2015, with 'transitional fixed protection' available for those whose pension funds were expected to exceed £1.25m by 5 April 2014 and 'individual protection' for those whose pension funds actually exceeded that figure on 5 April 2014.

Previous limits were

- *From 6 April 2006 to 5 April 2007 £1.5m*
- *From 6 April 2007 to 5 April 2008 £1.6m*
- *From 6 April 2008 to 5 April 2009 £1.65m*
- *From 6 April 2009 to 5 April 2010 £1.75m*
- *From 6 April 2010 to 5 April 2012 £1.8m*

The **annual limit**, which applies to inputs in 'pension input periods' ending in a tax year, is £50,000 from 2011/12 to 2013/14 but fell to £40,000 for 2014/15 et seq.

The limit is increased by any shortfall in pension inputs below that limit in the previous 3 years, provided that the member was in a registered pension scheme in that earlier year (and where the previous years included any before 2011/12 assuming the lifetime limit for such years was £50,000 and the multiple for accrued benefit schemes is 16)

Previous limits were

- *2006/07 £215,000*
- *2007/08 £225,000*
- *2008/09 £235,000*
- *2009/10 £245,000*
- *2010/11 £255,000*

The term 'pension inputs' embraces contributions to personal pension policies and retirement annuity contracts, contributions met by deduction from pay, employers' contributions to defined contributions schemes and benefits accrued in defined benefits schemes met by employers

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Each pension arrangement has a ‘pension input period’ (‘PIP’). The first PIP ends on the first anniversary of its beginning, unless an earlier date is nominated. Successive PIPs (which may not exceed 12 months) end on each anniversary of that first end date unless, again, an alternative date is nominated – which must be in the tax year following that in which the preceding PIP ended. Since 19 July 2011 a nomination cannot be retrospective

Income tax relief

Income tax relief is available on all pension inputs made by or for an individual under 75 (other than any made by his employer) up to a maximum of the individual's earnings [which expression includes income from UK and EU furnished holiday lettings] or, if more £3,600.

Schemes established by employers may use the net pay arrangements; deducting tax under PAYE only on earnings net of pension contributions. Contributions to retirement annuity policies are payable gross. Contributions to other pension schemes attract basic rate tax relief by deduction at source, with taxpayers paying tax at a higher rate claiming relief at the excess through their self-assessment tax return.

Employers will get tax relief on contributions made in respect of their employees, even if the employee is over 75, save that, where made by a trader, they will have to satisfy the 'wholly and exclusively' test.

Employees are not taxable on their employer's contributions or benefits accrued under a defined benefit (final salary) scheme as a benefit; save where the annual limit is exceeded, as explained below.

Different rules apply to people who are not resident in the UK, with some relief available where in the previous five tax years they were either resident in the UK or have UK chargeable earnings.

Exceeding the Annual limit

An individual whose ‘pension inputs’ in pension input periods ending in a tax year exceed the limit for that year is liable to income tax on the excess, through their self-assessment tax return. For years up to 2010/11 any such excess was charged at 40%. From 2011/12 any excess is charged at the individual’s marginal rate. He or she would have had income tax relief on their contributions (or not been taxed where the contributions are by their employer).

For years up to 2010/11 £10 of value was attributed to every £1 of defined benefit pension accrued, in valuing accrued benefits in a defined benefits scheme in the context of the annual limit. For 2011/12 et seq. this is increased to £16.

Example

Anne is in a defined benefits pension scheme giving her n/60ths pension at age 60. She has 25 years service and receives a salary increase from £52,000 to £60,000. Her pension fund becomes 25/60ths of £60,000 x 16 = £400,000. The previous year it was 24/60ths of £52,000 x 16 = £332,800. Indexation might increase this by 2.6% to £341,453. So Anne’s pension inputs are £58,547 [£400,000-£341,453]. Unless Anne’s pension inputs in the preceding three years fell short of the annual maximum, so that she can use the shortfall; she would have an income tax liability at her marginal rate on the excess over the annual maximum (£50,000 for 2011/12, 2012/13 and 2013/14 but £40,000 thereafter).

For years up to 2010/11 the pension inputs in a year in which the individual becomes entitled to all the benefits from a pension arrangement or in which he dies were ignored. From 6 April 2011, this will only apply to the year in which the individual dies or retires through severe ill health.

The lifetime limit

On drawing benefits the lifetime limit will apply. Subject to that limit, up to 25% of the "matured pension savings" may be drawn as a tax-free lump sum. The remainder must be drawn as an income subject to income tax. A single factor is adopted for valuing defined benefits against the lifetime allowance - 20:1 at all ages.

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Where the pension funds are relatively small the whole fund may be taken as a lump sum, of which 75% will be taxable. For 2006/07 to 2010/11 this 'trivial commutation' was available to those over 65 whose pension funds were no more than 1% of the lifetime limit. From 6 April 2011 it was no longer linked to the lifetime limit, but remained £18,000. This is increased to £30,000 from 6 April 2014.

Until 5 April 2015 if the pension fund exceeds the lifetime limit the excess is liable to a 'lifetime allowance charge' at 25%, or 55% if drawn, but will not be subject to tax as income. The Chancellor said in the March 2014 Budget that from 6 April 2015 for defined contribution schemes the 'cap' – the lifetime limit – will be removed; 25% of the pension funds may be drawn tax-free and the balance may be drawn at will (or used to buy an annuity) but then taxed as income. People in serious ill health who have a severely reduced life expectancy may draw the whole of their pension funds, if no more than the lifetime limit, as a lump sum. This is tax-free if the member is under 75, but subject to tax at 55% otherwise. This too might change from 6 April 2015. The position for defined benefit (final salary) schemes has not yet been decided.

Drawdown

From 6 April 2011 'drawdown' for those under 75 and the previously called 'alternatively secured income' are both termed 'drawdown pension'. There is no obligation at all to buy an annuity at any age. Up to 5 April 2015 the maximum annual income that may be withdrawn is 150% [120% for 'drawdown pension years' beginning before 27 March 2014] of the equivalent annuity [a figure to be reviewed every three years until age 75, annually thereafter], unless the member has a lifetime pension income of at least £12,000 a year [£20,000 before 27 March 2014], in which case there is no cap on the amount he may draw. The maximum dependant's drawdown pension is calculated in the same way as that of the member.

Inheritance tax is not charged on drawdown pension funds remaining except where pension scheme trustees have no discretion with regard to the distribution of lump sums after the member's death.

These are the rules applicable before 6 April 2015, from which date, on the basis of what was said in the March 2014 Budget, after drawing 25% tax-free any amount may be drawn as taxable income from defined contribution schemes. Nothing was said as regards inheritance tax. There must be a strong possibility that inheritance tax will apply to any pension fund remaining after 5 April 2015 once the member and any surviving dependant has died.

Transitional position

Primary protection - Where an individual had pension rights valued in excess of £1.5 million at 6 April 2006 ('A-Day'), he or she could have given notice of his intention to rely on that value by 5 April 2009. Values that are registered are expressed as a percentage of the statutory lifetime allowance. For example, for someone who had a fund of £2.25 million at A-Day, the percentage will be 150%. By expressing the A-Day value in percentage terms, the value will be automatically indexed in parallel with the change in the lifetime allowance. When the pension vests, the individual can take benefits, in this example up to 150% of the value of the statutory lifetime allowance in that year, without incurring any tax liability under the recovery charge.

Enhanced protection - There was an alternative approach for the protection of pre A-Day pension funds against the recovery charge. This is available for those who, before A-Day, stopped contributing to their pension funds. This is not restricted to individuals with pension values exceeding £1.5 million. Under this alternative approach all post A-Day increases in the value of pension funds and benefit rights accrued before A-Day are protected from the recovery charge. Notice of an intention to rely on this protection had to be given by 5 April 2009.

Anyone who has taken the alternative approach may resume active membership of a pension scheme any time before they reach age 75. For those who resume active scheme membership, protection from the recovery charge will be determined by their A-Day pension value. For those whose pension value did not exceed £1.5 million, their personal lifetime allowance will be 100% of the lifetime allowance. For those who registered pension values exceeding £1.5 million,

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their personal lifetime allowance will revert to the percentage of the lifetime allowance which corresponded to the value of their pre A-Day fund.

Those who registered funds in excess of £1.5 million at A-Day will also protect any tax-free lump sum entitlement over £375,000. After A-Day they can take the amount of the pre A-Day lump sum rights increased to the same extent as the increase in the lifetime allowance.

People who retain enhanced protection from the recovery charge can take 25% of the pension value vesting after A-Day as a tax-free lump sum.

At A-Day some members of occupational schemes, who had not registered for transitional protection, will have been entitled to a tax-free lump sum in excess of 25% of the value of their pension benefit. At vesting they will be able to take the tax free lump sum to which they were entitled at A-Day, increased to the same extent as the increase in the lifetime allowance to the date of vesting.

Pensions already in payment at A-Day are treated as having used up part of an individual's lifetime allowance where, after A-Day, the individual has a new benefit coming into payment. The factor for valuing such pensions is 25:1. Where income is being drawn from a pension fund under an income drawdown arrangement, the annual level of the pension in payment is deemed to be the maximum permitted annual income determined at the most recent valuation of the member's fund.

Fixed protection 2012 was available from 6 April 2012 for those without existing protection and whose pension funds already exceeded £1.5m then, provided that there are no pension inputs on or after that date.

Fixed Protection 2014 could be claimed before 6 April 2014 for those without existing protection and whose pension funds were expected to exceed £1.25m then, again provided that there are no pension inputs on or after that date.

Individual Protection 2014 may be claimed, by those whose pension funds exceeded £1.25m at 5 April 2014, so that their lifetime limit is equal to the value of their pension funds at that date, but with a maximum of £1.5m.

Those whose transitional protection depends on having no further pension inputs need to be alert to the possibility of involuntary contributions following auto enrolment in a workplace pension scheme.

Death benefits

On the death of a member under the age of 75 before drawing pension benefits a scheme may pay a lump sum which is free of tax.

On death after 5 April 2011 while receiving pension benefits, regardless of age, lump sum benefits (as opposed to income benefits to survivors or dependants) are taxed at 55%.

As noted above, there is not normally an inheritance tax liability on death after 5 April 2011.

No indication has been given whether this will change from 6 April 2015.

Employer-Financed Retirement Benefit Schemes (EFRBS).

Unapproved Schemes - FURBS (funded unapproved retirement benefit schemes) and UURBS (unfunded unapproved retirement benefit schemes) no longer receive tax-favoured status. They are now referred to as Employer-Financed Retirement Benefit Schemes (EFRBS).

As any future retirement provision made through the equivalent of unapproved pension schemes do not attract any specific tax privilege, amounts saved in any such scheme are not tested against the annual and lifetime allowances and the recovery charge does not apply to them. For unfunded schemes the value of the promise to pay a pension on retirement will not be taken into account when considering the annual allowance and will not be tested against the lifetime

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allowance. When benefits are paid out, whether by lump sum or pension, they will be fully subject to tax at the member's marginal rate.

- Contributions by an employer to an EFRBS will not result in a tax charge on the employee or be liable to NICs, but nor will the employer get any deduction for his contributions until benefits start to be paid to the employee.
- An EFRBS is subject to tax on its income and capital gains.
- Benefits paid out by the EFRBS will be liable to income tax within the general taxation provisions, subject to transitional protection.
- Benefits paid out by the EFRBS will not be subject to employers' or employees' NICs if the benefits are consistent with the general benefit rules for an approved scheme.
- An EFRBS has no inheritance tax-favoured status, subject to transitional protection.

Transitional protection for EFRBS

A tax-free lump sum may be taken from an EFRBS if the scheme started before December 1993 and it has not been varied subsequently, or all of the scheme's income and gains have been taxable and no contributions have been made since 5 April 2006. Otherwise a lump sum is only tax-free to the extent that it doesn't exceed the amount of employer contributions made before 6 April 2006 and any employee contributions. In either case this is conditional on the employee having been taxed on the employer’s contributions as they were made.

Amounts in a FURBS at 5 April 2006 will continue to retain their previous inheritance tax treatment. Where additional contributions are made after 5 April 2006, funds will be apportioned.

Any UURBS in place on the day before 6 April 2006 could have been consolidated and rolled into a registered scheme before 6 July 2006. The increase in value of benefits in the registered scheme caused by the incorporation of the UURBS did not count towards the annual allowance but will be tested against the lifetime allowance when vested.

A UURBS consolidated and rolled into a registered scheme at any other time will count towards both the annual allowance and the lifetime allowance.

Previously approved schemes had the choice of opting out of the new regime at 5 April 2006. Where they did so, the new regime imposed a 40% tax charge on fund assets immediately before opt-out. This charge was to recover the tax relief originally given. Funds withdrawn from the scheme after 5 April 2006 are subject to tax and NIC, with no entitlement to a tax-free lump sum.

Surpluses

Because benefits will be unlimited (albeit with a varying tax burden), the concept of surplus falls away almost entirely in defined contribution schemes. However, a surplus could arise for defined benefit schemes. Department of Work and Pensions (DWP) rules will be relied on to determine when a surplus arises in a defined benefit scheme. When a surplus is paid to an employer, there is a tax charge of 35%.

Investment

There is a single set of investment rules. They were to be simple, flexible and impose as few restrictions as are compatible with prudent standards. As originally envisaged, the new regime would, subject to DWP requirements, have allowed pension schemes to invest in all types of investments, including residential property. However, the Government, seemingly swayed by Press comments that misunderstood the tax position imposed restrictions [in the form of draconian tax penalties] on certain investments made by 'self-directed' pension schemes such as self-invested personal pension schemes (SIPPS). Those affected are investments made directly or indirectly in residential property or 'tangible movables'. It is notable that this expression goes well beyond the words used in the December 2005 Pre-Budget Report, which referred to certain other assets such as fine wines, classic cars and art & antiques.

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For all schemes,

- there is a limit for shareholdings in the sponsoring employer and associated/connected companies of 5% of fund value.
- loans to members are not allowed.
- loans to employers, other than in the form of bonds issued on the open market, must
    - be secured as a first charge, on assets that are and will remain of at least equal value to the face value of the loan
    - have an interest rate at least equal to the Corporation Tax SA rate up to the normal due date
    - not last for more than 5 years
    - not be more than 50% of the value of the fund at the date the loan is taken out
    - be repaid either by equal annual instalments of capital or by equal annual instalments.
- scheme borrowing will be limited to 50% of scheme assets at the date the loan is taken out.

The minimum retirement age is 55 (subject to an exception for ill health retirement).This applies even to those such as certain professional sportsmen whose retirement age is lower than 50. But the Government allows people in pension schemes at A-Day with a low normal retirement age to keep their existing rights to take benefits early, but subject to two conditions

- the pension will be tested against a reduced lifetime allowance
- the full pension must be vested.

A reduction of 2.5% will be applied to the lifetime allowance for each year before 55 that the pension is taken. For example a pension taken at age 35 would reduce the lifetime allowance of that individual by 50%. The pension fund would therefore be valued against 50% of the prevailing lifetime allowance. 50% of the lifetime allowance would remain unused and could be carried forward for use in determining the amount of any further tax-privileged savings that could be built up.

The reductions in the lifetime allowance are not to apply to members of the armed forces and police and fire services. Deferred and active pension scheme members at A-Day with a contractual right to draw a pension after 50 have that right protected, so long as that right was extant at 10 December 2003.

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