Technical CONNECTION

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PRE-BUDGET REPORT 2006 AND PENSIONS

The Chancellor's 2006 Pre-Budget Report very much followed the lines of his previous Pre-Budget Reports. Significant changes were made/proposed for pensions and so we have concentrated on pensions in this issue.

Our comments are highlighted in italics.

1. ALTERNATIVELY SECURED PENSIONS

A number of changes are to be made to the ASP rules with effect from 6 April 2007. These will effectively sound the death knell for the concept of the "family SIPP".

(a) Minimum income

With effect from the first "ASP year" starting on or after 6 April 2007, a member (or dependant taking dependant's ASP) must take a minimum income of at least 65% of the "basis amount" (ie. the annuity based on GAD rates for an individual aged 75) in each ASP year.

The only exceptions to the above will be in

- the "ASP year" which ends immediately before the death of the member or dependant, or
- the "ASP year" in which all of the member's/dependant's ASP funds are used to provide a scheme pension, lifetime annuity, dependant's scheme pension or dependant's annuity, as appropriate.

Where the member or dependant does not take an income of at least the minimum level in an "ASP year", the difference between the minimum income level and the actual income paid will be treated as a scheme chargeable payment, and result in a scheme sanction charge.

For example, Joe was taking ASP and the minimum income level for an "ASP year" was determined as £10,000. However, no income was paid to Joe in that year. This results in a scheme chargeable payment of £10,000. The scheme administrator will therefore be liable to a scheme sanction charge of £4,000 (ie. 40% x £10,000). There is no mention in the draft legislation of any shortfall in the minimum income level being treated as an unauthorised member payment.

The above could create a major problem for those providers who currently use ASP as a means to hold in suspense the funds of members which they have been unable to trace by age 75. If the legislation were applied to these members a scheme sanction charge would apply each year as no income will be being paid. HMRC has recognised this problem and says it will discuss with interested parties what alternative provisions are needed to address this.

(b) Maximum income

With effect from the first "ASP year" starting on or after 6 April 2007 a member may take a maximum income of 90% of the "basis amount" (as defined in (a) above).

(c) Treatment of "Transfer Lump Sum Death Benefit"

Under the existing rules, where a member (or dependant) taking ASP dies without leaving a dependant of the member it is possible for the deceased member's (or dependant's) ASP fund to be paid as a "Transfer Lump Sum Death Benefit" to enhance the benefits of another scheme member. Such a payment is an authorised lump sum payment.

With effect from 6 April 2007 any "Transfer Lump Sum Death Benefit" will no longer be an authorised lump sum payment. Instead, it will be subject to an unauthorised payments charge of up to 70% where the deceased member's residual ASP fund is transferred to the pension fund of another member(s) of the scheme. Rights payable in these circumstances will be renamed as "alternatively secured rights".

The payment of such rights to another member will be treated as an unauthorised payment to that member (or that member's personal representatives).

On the basis of the draft legislation it appears that the recipient of the "alternatively secured rights" will have to find up to 55% of the value of those rights from their own resources to meet the unauthorised payment charge and unauthorised payment surcharge.

The scheme will presumably deduct the remaining 15% from the "alternatively secured rights" to meet the scheme sanction charge. A problem could arise for the scheme administrator where the recipient is unable or unwilling to meet the unauthorised payments charge as this would result in an increased scheme sanction charge (ie. up to 40%).

HMRC has indicated that the IHT charges, as set out in sections 151A – 151C of the IHT Act 1984, will continue to apply. It will, however, consider "how best to ensure the rules work and interact with the new unauthorised payment provisions" and will discuss this with interested parties.

The combination of the IHT and unauthorised payments charge will severely limit the use of ASP and certainly destroy any idea of using it as a "family SIPP". The following example demonstrates how the combined tax charge may operate.

Elsie was taking ASP from a SIPP, and died in May 2010 leaving a residual fund of £500,000. As Elsie had no dependants the fund became "alternatively secured rights" as it was made available to provide benefits for Fred, another member of the SIPP. When the IHT charges were introduced by the Finance Act 2006 it was indicated that the IHT charge will take precedence over the pension scheme charge, and it is presumed that this will continue to be the case in this instance. In total Elsie had an estate of £1,000,000 (in addition to the residual ASP fund) and an unused nil rate band of £300,000.

The scheme administrator calculates the share of the IHT due attributable to the residual ASP fund as follows:

Residual ASP fund	=			*£500,000*
less				
Share of nil rate band	=	*£500,000* / *(£1,000,000 + £500,000)*	*x £300,000 =*	*£100,000*
Taxable amount				*£400,000*
IHT payable at 40%				*£160,000*

The scheme administrator will be responsible for accounting for and paying any IHT attributable to the residual ASP fund.

The residual ASP fund, after payment of the IHT charge, of £340,000 will be subject to an unauthorised payments charge (55%) on Fred of £187,000. However, Fred will have to find this from his own resources as the fund will remain within the SIPP.

In addition, the scheme administrator will be liable for a scheme sanction charge of £51,000 (15% x £340,000) and this will reduce the fund to £289,000.

Therefore Fred will have had to have met a tax liability of £187,000 to obtain a pension fund of £289,000.

The effective tax position on the addition of the residual ASP fund to the estate can be summarised as follows:

Residual ASP fund on Elsie's death	*£500,000*
Effective rate of IHT on the fund (40%)	*(£200,000)*

Scheme sanction charge	*(£51,000)*
Unauthorised payments charge	*(£187,000)*
Net benefit	*£62,000*

The overall effective tax charge is therefore 87.6%.

The position could be even worse if the de-registration threshold has been reached by Elsie's SIPP as this would result in an additional tax liability of £115,600 (ie. £289,000 x 40%) resulting in an effective tax rate of over 110%.

It is worth noting that the smaller the size of the deceased member's estate relative to the residual ASP fund, the higher will be the effective rate of tax. This is because the share of the nil rate band allocated to the residual ASP fund will be higher and thus the IHT deducted from the residual ASP fund will be proportionately less.

The only authorised payments in respect of the residual ASP fund will be where they are paid:

- to provide dependant's pension benefits
- as a charity lump sum death benefit
- in limited circumstances to the non-connected employer

(d) Members/dependants who died before 6 December 2006

The provisions set out in (c) above will not apply in respect of the reallocation of the residual funds of a member/dependant taking ASP who died before 6 December 2006. The reallocation of the fund in respect of such members will not be treated as an unauthorised payment.

(e) Members/dependants who die between 6 December 2006 and 5 April 2007

Where a member/dependant taking ASP dies between 6 December 2006 and 5 April 2007 any reallocation of the member's/dependant's residual fund to another scheme member will fall within the new rules in (c) above, but only where the allocation of those funds takes place on or after 6 April 2007.

(f) Guarantee period

Any payments under a guarantee from an ASP fund will be unauthorised payments with effect from 6 April 2007. This means that no authorised payments of pension may be made from the member's ASP fund after his/her death (other than dependants' pension benefits).

It appears that ASP members with a guarantee set up prior to 6 April 2007 will still be affected by this change although this needs to be clarified. It is interesting that although this facility is being removed it will still be possible for a member prior to age 75, or for a member taking ASP, to set up a lifetime annuity with a guaranteed payment period of up to 10 years. For example, an annuity of around £8,700 could be paid in respect of a £100,000 purchase price for a male aged 74. If the member died immediately after taking the annuity, it would have a value for IHT purposes (using HMRC's IHT calculation tool) of around £44,800. This could represent an interesting alternative to ASP.

(g) Payment of Charity Lump Sum Death Benefits

The draft legislation will amend the legislation concerning who can nominate where a Charity Lump Sum Death Benefit is paid, giving greater power to the scheme administrator.

The change will enable a scheme administrator to select a charity to which a Charity Lump Sum Death Benefit may be paid, in the absence of a member nomination (in respect of the member's ASP funds) or in the absence of a member or dependant nomination (in the case of lump sums paid to a charity out of a dependant's ASP fund).

This change has presumably been made by HMRC to try to direct any remaining ASP funds to a charity, rather than to provide a windfall for the scheme provider.

(h) Transitional Provisions

HMRC has indicated it will consult with interested parties to confirm that those members of registered schemes who either already have ASP funds, or will shortly be in that position, will after 5 December 2006 be able to reorganise their affairs to prevent them becoming liable to tax charges imposed by the removal of the Transfer Lump Sum Death Benefit facility as an authorised lump sum death benefit and by the removal of the guarantee facility.

(i) The future

In paragraph 5.14 of its report on the annuities market, HMRC indicates that the above proposals concerning ASP "will bring practice and policy intention into line, and provide a fair balance between meeting the needs of those with principled religious objections to annuitisation and the needs of the wider public who are provided with tax relief in order to enable individuals to produce an income in retirement. However, if these proposals prove unworkable, or there is continued evidence of use of pension tax relief to provide capital sums after retirement, the Government will need to consider whether to remove access to ASP altogether".

2. SCHEME PENSIONS

HMRC has become aware of plans to use the rules for scheme pensions in order to preserve the maximum remaining pension fund on the death of a scheme member and allocate this to the pension funds of other members of the scheme, who were connected with the deceased.

HMRC has indicated that it will introduce measures in the Finance Bill 2007 to prevent scheme pensions being used as a route to pass on tax-favoured pension savings. These measures will have effect on and after 6 April 2007.

As the changes will presumably be applied to the position on the death of the member on or after 6 April 2007 the announcement concerning scheme pensions in the Pre-Budget Report will stop the use of this vehicle in the above manner with immediate effect.

It will be important to know whether any "affected" scheme pensions set up prior to 6 December 2006 will be exempted from the changes, or whether an exemption will only apply to members with such benefits who died on or before 5 December 2006. The position also needs to be clarified of what happens to a member with an "affected" scheme pension set up prior to 6 December 2006 who dies before 6 April 2007.

3. PENSION TERM ASSURANCE

The introduction of the new pensions tax regime had seen a considerable increase in the volume of individual pension term assurance sales. Reports in the press have indicated sales of more than 100,000 term assurance policies. Many new products were launched to address this market where the tax relievable premiums made such contracts more attractive, in many cases, than non-pension term assurance policies.

In paragraph 5.77 of the main "Pre-Budget Report" it is made clear that the Government regards the above as contrary to the reasons for granting pension tax relief. The Government therefore intends to work with the pensions industry to explore, in time for the 2007 Budget, how the Government's policy intention in relation to pension plans can be applied to pension term assurance contracts. Any changes the Government decides to make will not affect either personal arrangements entered into before 6 December 2006 or existing types of employer arrangements.

The above would certainty seem to herald the end for tax-relieved pension term assurance, and this is reflected by most leading insurers withdrawing their pension term assurance contracts. It will only be once the detailed proposals are produced that it will be possible to fully understand what is meant by the exemption in respect of "existing types of employer arrangements". Presumably this is intended to cover death-in-service arrangements set up by an employer, but will this also cover one person pension term assurance arrangements set up by an employer where the employer is paying the contribution?

4. INVESTMENT-REGULATED PENSION SCHEMES AND UK-REITS

If an investment-regulated pension scheme is to avoid having its investment in a UK-REIT, on or after 1 January 2007, treated as creating an indirect holding in any taxable property held by the UK-REIT, it together with any associated persons must restrict the holding to less than 10% of the UK-REIT. The appropriate legislation to implement this will be included in the Finance Bill 2007. This move was partly prompted by another proposed change to REITs legislation aimed at making it easier to launch new (as opposed to conversion) REITs.

5. MISCELLANEOUS CHANGES

(a) Transitional protection from the lifetime allowance charge

Provisions will be included in the Finance Bill 2007 to safeguard a member's transitional rights to an enhanced lifetime allowance where

- individuals make partial transfers
- there are bulk transfers of employees due to the sale of a business
- where members transfer to new occupational death-in-service arrangements and
- where the terms of a life policy in an occupational scheme are varied to comply with the Age Directive.

The first two bullet points will take effect from 6 April 2007, while the remaining two bullet points will be effective from 6 April 2006.

(b) Ill-health pensions

An amendment will be included in the Finance Bill 2007 to allow scheme pensions paid early on ill-health grounds to be reduced at the discretion of the scheme administrator. Previously the legislation had permitted an ill-health pension to be stopped (but not reduced) if a member's health recovers.

This new provision, which will have retrospective effect from 6 April 2006, will enable a scheme to reduce a member's ill-health pension where the member has made a partial recovery.

(c) Pension Commencement Lump Sum (PCLS)

An amendment will be included in the Finance Bill 2007 to permit a PCLS to be paid within 12 months of a member becoming entitled to a scheme pension, lifetime annuity or income withdrawals under an unsecured pension. The PCLS can also be paid where part of the 12 month period falls after the member's 75th birthday (although it is presumed that the related pension must have commenced before age 75). This change will apply retrospectively from 6 April 2006.

(d) Review of income withdrawal - unsecured pension

Provision will be included in the Finance Bill 2007 for more frequent reviews of the annual maximum allowable income withdrawal than the current 5 yearly basis. Such reviews may in future be undertaken at the end of each unsecured pension year, but only at the direction of the member. The requirement that the maximum withdrawal needs to be reviewed at least every 5 years will remain. This change will apply retrospectively from 6 April 2006.

(e) Two year time limit – payment of lump sum death benefit

An amendment will be included in the Finance Bill 2007 in respect of any payment of a lump sum death benefit on or after 6 April 2008 in respect of a member who died on or after 6 April 2006.

In such cases the lump sum death benefit must be paid within 2 years of the scheme being notified of the member's death, but if the scheme could have been reasonably aware of the member's death at an earlier date the 2 year period will start from that earlier date.

(f) Winding-up lump sums

A change will be included in the Finance Bill 2007, effective from 6 April 2006, to indicate that the conditions that need to be met by the employer for a winding-up lump sum to be paid apply only to the member's current employer at the time the winding-up lump sum is paid and not to any previous employer.

(g) Establishment of schemes

The Finance Bill 2007 will include the provision that a person will need permission from the FSA in order to establish a (non-occupational) registered pension scheme with effect from 6 April 2007. This is required as part of the FSA regulation of SIPP providers.

(h) Trivial commutation lump sums

Over the next few months HMRC will discuss concerns raised by the pensions industry over the administration involved in the checks they are required to make when paying trivial commutation lump sums.

(i) Consultation on BCE3 and dependant's scheme pension

HMRC is consulting on potential changes to the rules regarding BCE3 (pension increases) and dependant's scheme pension where this is currently restricted on the death of a member with a scheme pension after age 75. Any such changes would be included in the Finance Bill 2008 and take effect from 6 April 2008.

Concern has been expressed to the Government that both of these rules are complex to administer and are disproportionate in that they apply to all scheme members when in fact only a small proportion of members will have a risk of exceeding the lifetime allowance limits.

6. THE ANNUITIES MARKET REPORT

This report sets out the Government's latest thinking on the "at retirement/decumulation" market. It reaffirms the Government's commitment to annuitisation and its concerns that pensions tax relief is granted to encourage provision of an income in retirement and not as a means of passing on capital sums to heirs.

The Government feels its changes under the new pensions tax regime have encouraged more flexibility in the decumulation market and foresees the growth of new "mid-market" annuities, which are a cross between annuities and drawdown. It specifically rejects the idea floated for consideration by the Second Report of the Pension Commission that individuals should be required to annuitise only up to a certain level of income, and be able to take the remaining cash out of their fund subject to a tax charge.

WE WISH ALL OUR READERS A PROSPEROUS AND HAPPY NEW YEAR