Technical Connection

CONTENTS

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RETIREMENT BENEFITS BEYOND AGE 75

Consultation document issued
Removal of the effective need to annuitise at age 75

In its consultation document on the removal of the effective need to annuitise at age 75, the Government has set out a number of radical proposals.

In summary, the main proposed changes are:

a) Retirement benefits

- From 6 April 2011 there will no longer be any specific date (eg 75th birthday) by which members of registered schemes have to 'annuitise' or otherwise secure their benefits. There appears to be no requirement to crystallise benefits at all, although there will still be a lifetime allowance test at age 75.

- Capped drawdown (broadly USP as at present) will still be available and can continue beyond age 75. The capped maximum will be reviewed in the coming months.

- There will be an option to take flexible (unlimited) drawdown amounts, provided the member can meet the Minimum Income Requirement (MIR) test at the point flexible drawdown begins.

- ASP is to be abolished from April 2011. Existing ASP members will become subject to capped/flexible drawdown rules, including those for death benefits.

- PCLS can be taken when benefits crystallise, even if this is after age 75.

b) Death benefits

- Any lump sum death benefit will be subject to a tax recovery charge of 55%. No charge will apply to lump sums paid in respect of uncrystallised benefits where the member dies before age 75.

- Value protected lump sums can be paid irrespective of whether the member dies before or after age 75.

- Except for cases where section 3(3) of the IHT Act 1984 is concerned, any lump sum death benefits, paid at the discretion of the scheme administrator/trustees, should be paid free of IHT. This is irrespective of whether the lump sum death benefit is paid before or after age 75. HMRC will, however, be monitoring this position carefully to ensure that the 55% tax rate does not leave open incentives for pension saving to be used to reduce inheritance tax liabilities.

c) Benefit testing and tax relief

- Benefits will be subject to lifetime allowance testing at age 75. It is presumed these will be tested under a deemed BCE1 in respect of uncrystallised benefits and a deemed BCE5A in respect of benefits in capped/flexible drawdown at age 75.

- Tax relief on member contributions will only continue to be available where these are paid prior to the individual's 75th birthday.

CONSULTATION ON AUTUMN FINANCE BILL

HM Treasury consults on the content of the Autumn Finance Bill

Following the June 2010 Budget, HM Treasury recently announced that the Government intends to take steps "to ensure that changes to the tax system receive adequate scrutiny". With this in mind, the Government has published draft legislation on technical tax measures that were inherited from the previous Labour government that are to be legislated for in a Finance Bill to be introduced to Parliament in the Autumn.

The consultation (which will close on 3 September 2010) seeks comments on whether the legislation will work as intended rather than seeking comments on the policies themselves. A total of 32 pieces of draft legislation, accompanied by draft explanatory notes, have been made available for comment.

FINANCE BILL 2010 – PENSION PROVISIONS

The pension provisions of the Finance Bill are set out in clauses 5 and 6 and Schedule 3.

- **Repeal of the high income excess relief charge**

Clause 5 gives HM Treasury the power to repeal the high income excess relief charge provisions as set out in section 23 and Schedule 2 to the Finance Act 2010. This will otherwise take effect from 6 April 2011. In the June 2010 Budget the Government announced its intention to replace this charge with a reform of the existing allowances, principally by means of a significantly reduced annual allowance which it indicated could be between £30,000 and £45,000. This will be subject to consultation and the Government has confirmed that a discussion paper will be issued in summer 2010.

If this legislation is to be repealed an appropriate order to do so must be made on or before 31 December 2010.

- **Interim provisions on the removal of annuitisation at age 75**

Clause 6 and Schedule 3 cover the interim provisions introduced for those individuals reaching age 75 on or after 22 June 2010 with either uncrystallised funds and/or unsecured pension funds, pending the introduction of the new rules to abolish compulsory annuitisation at age 75. These new rules are expected to take effect from 6 April 2011 and the Government is launching a consultation on this imminently.

In the meantime, these provisions in the Bill effectively extend the current unsecured pension provisions, for those individuals reaching age 75 on or after 22 June 2010, from age 75 to 77. HMRC has issued detailed technical guidance concerning these changes. These changes mean:

- an unsecured pension may be paid as an authorised pension to a member or dependant until their 77th birthday;
- an alternatively secured pension fund is not created until a member's or dependant's 77th birthday; and
- an unsecured pension lump sum death benefit may be paid until the member's or dependant's 77th birthday.

Where such an individual dies between age 75 and 77 an unsecured pension lump sum death benefit can be paid in exactly the same way as had death occurred before age 75. Such a payment will be subject to an automatic tax charge of 35% and will not normally be subject to IHT where the lump sum is paid at the discretion of the scheme administrator/trustees. It should, however, be remembered that a liability to IHT could still arise under section 3(3) of the Inheritance Tax Act 1984 (ie under the 'error or omission to act' provisions) where a scheme member has not taken benefits when first eligible to do so in order to augment the benefits available on his death.

Where a short-term annuity reaches the end of its term because the member reaches age 75 on or after 22 June 2010, a new short-term annuity may replace it with a term which runs until the individual's 77th birthday.

Despite the above change, where such a member had uncrystallised funds as at age 75 on or after 22 June 2010 a BCE1 test will apply at age 75. This will be applied to the total amount of the member's uncrystallised funds even though a part of that fund may be used to secure a PCLS either at that time or within 12 months of the member's 75th birthday. To avoid double counting the normal BCE6 test in respect of a PCLS will not be applied. If the member has not taken his PCLS by 12 months after his 75th birthday, and he has not otherwise used that fund in the meantime to increase his unsecured pension or buy a lifetime annuity or scheme pension, the remaining unused fund will be used to increase his unsecured pension. Where the member dies in the 12 month period after his 75th birthday, and before he had taken his PCLS, it will be assumed that the remaining fund in respect of the PCLS had increased his unsecured pension fund on the day before his death, enabling this to form part of the unsecured pension lump sum death benefit.

Where a member reaches age 75, on or after 22 June 2010, with an unsecured pension (in the form of income withdrawals) a BCE5A test will be undertaken at age 75 even where his benefits continue as an unsecured pension. Where such a member's benefits are continued beyond age 75, the maximum allowable income withdrawal will continue to be based on that applicable at his last 5 year review. Where the five year review period ends on or after his 75th birthday a new review will be undertaken, based on the assumption he is aged 75 (irrespective of his actual age).

The existing rules regarding untraceable members at age 75 will now not be applied until age 77 for a member who reaches age 75 on or after 22 June 2010. A BCE1 calculation will still, however, be undertaken at age 75 for such individuals.

It should be stressed that the above transitional treatment only applies to those individuals reaching age 75 on or after 22 June 2010. For those individuals who are already in ASP, the tax treatment will continue as under the current legislation, including the combined draconian tax charges of up to 82% where a lump sum is paid on the member's death other than to a charity. Of course, the position for such individuals is likely to be amended once the new legislation takes effect on 6 April 2011.

A number of money purchase schemes only provide for unsecured pension arrangements to apply to age 75, and do not offer ASP. The transitional tax rules therefore include a statutory override which will allow the trustees or managers of a scheme with a scheme rule of this kind to treat a person as not having reached the age of 75 where that person does not reach age 75 until on or after 22 June 2010 and has not reached the age of 77. This will permit unsecured pension arrangements to continue to age 77. The scheme administrator/ trustees of such schemes will have the discretion on whether to take advantage of this statutory override.

The transitional provisions only apply to those individuals in a money purchase scheme reaching age 75 on or after 22 June 2010 with either uncrystallised funds or funds under an unsecured pension. It does not cover those individuals who are taking a lifetime annuity or a scheme pension (including those where the scheme pension is being paid out of the funds of a SIPP or SSAS). This means that any member now approaching age 75 with uncrystallised benefits, and considering whether to take an unsecured pension or elect for a scheme pension payable from scheme funds, would generally be best advised to opt for the unsecured pension. This would benefit from the more favourable IHT treatment on death between ages 75 and 77 and would give the member the opportunity to reconsider the decision when the new legislation takes effect from 6 April 2011. By contrast, if the member elected for a scheme pension and died after age 75 and before the new legislation takes effect any lump sum paid to another scheme member would be subject to IHT and unauthorised payment charges that could total up to 73%. Moreover, once a scheme pension was selected there would be no opportunity to amend this to an unsecured pension should this prove to be a more attractive option under the new legislation.

COMMENT

The transitional death benefit provisions are to be welcomed. They give those individuals now reaching age 75 the ability to defer making any final choice concerning their retirement benefits until the new legislative provisions are known.

INCREASE IN THE INCOME TAX PERSONAL ALLOWANCE

An unexpected bonus for the over 65's?

In the Coalition Government's Budget statement there was a proposal to increase the income tax personal allowance by £1,000 with effect from 6 April 2011. This would take the personal allowance to £7,475. It was specifically stated in the Budget release that this would not apply to people aged 65 or over who, of course, benefit from age allowance at a current level of £9,490 (£9,640 for those aged 75 or over). In most cases it would therefore be reasonable to assume that people aged 65 or over would not be affected by this change. However, this is not necessarily the case.

The way the new personal allowance will work is to give the increased allowance to everybody. However, because the allowance is not available to higher rate taxpayers, the impact of the increase in the personal allowance will be neutralised by a reduction in the basic rate tax band by £2,500 – so it is based on taxable income of £34,900 rather than £37,400.

As the Government is committed to eventually increasing the personal allowance to £10,000, if the same cut back is made to the basic rate tax band each year as the personal allowance increases, this will mean that more and more people will become higher rate taxpayers just through natural increases in income.

Another consequence – that may be unintended – is that the wealthier pensioner may become £200 better off. This is because pensioners, depending on their age, qualify for age allowance of £9,490 or £9,640 but that is gradually reduced when total income exceeds £22,900. The way this abatement works is to reduce age allowance by £1 for every £2 of excess income until such time that the personal allowance is reduced to the basic personal allowance.

This year the basic personal allowance is £6,475 but with this probably increasing to £7,475 from next year, it means that these wealthier pensioners could well end up being some £200 better off ie £1,000 @ 20%.

Obviously, we will have to await the legislation which gives effect to the £1,000 increase in the personal allowance to be certain of this interpretation.

BASIS OF INFLATIONARY INCREASES FOR PENSIONS TO CHANGE

CPI to replace RPI

In a brief written statement issued on 8 July the Pensions Minister, Steve Webb, announced that the Consumer Prices Index (CPI) would replace the Retail Prices Index (RPI) 'in determining increases for all occupational pensions and payments made by the Pension Protection Fund (PPF) and Financial Assistance Scheme (FAS)'. The change will take effect for measuring price increases for the year to 30 September 2010. Thus 2011/12 PPF/FAS rises to pensions in payment and revaluations of deferred benefits will be the first affected.

The PPF/FAS revisions will require that the statutory revaluation orders made under the Pensions Act 1993 are based on CPI rather than RPI and, for increases in payment, that 'some small changes to primary legislation are made'. These will be brought before Parliament 'at the earliest opportunity'.

An important flow through from these reforms is that private sector defined benefit occupational schemes will also become subject to CPI rather than RPI as the basis for statutory revaluation of deferred benefits and Limited Price Indexation applied to pensions in payment.

The Minister justified the switch as being consistent with the Budget announcement that most DWP benefits would be linked to CPI rather than RPI. In practice a move in this direction was looking inevitable after Budget Day: once SERPS increases are CPI-linked it is hard to see how 1988-1997 GMP could otherwise be dealt with, given that the occupational scheme providing the GMP is currently required to make RPI increases up to 3% on GMP, but the state would then be making any top ups based on CPI.

After several days of confused press comment about which private sector pension benefits will be affected , the DWP issued a statement on 12 July clarifying two areas:-

- Contrary to some reports (eg the *Financial Times* of 10 July), the change from RPI to CPI will affect *all* benefits subject to statutory increases/revaluation, not just those accrued from April 2011.

- The change will not have retrospective effect. For example, someone who left pensionable service five years ago would see their preserved pension revalued in line with RPI in respect of the first five years after leaving service, and then in line with CPI until normal pension age. Once the pension comes into payment, annual increases will be CPI-based.

For private sector occupational schemes the move could be a significant money saver, as it will be for the government on the DWP benefits front. Since January 1990 the CPI has averaged 2.5% a year while the RPI average has been 3.1%. The current figures (for the year to May 2010) are 3.4% and 5.1%, a gap of 1.7%. Various estimates have started to appear suggesting that the potential reduction in future benefit increases change will create a one-off reduction in liabilities for private sector schemes worth between £50bn and £100bn. To put that in perspective, the PPF 7800 Index total deficit estimate for May 2010 was £196.8bn.

However, before the bonanza arrives for the DB sector, there remains a variety of issues to address:

- Some schemes will have RPI written into their trust deeds (CPI did not officially exist before 2003) and it is unclear from announcements so far whether there will be any overriding legislation to deal with this. The chances are there will have to be, if only because there will be times (as happened in 2009) when the RPI is *lower* than the CPI. Indeed, if the change from RPI to CPI had taken place using September 2009 data, pensions would have risen by 1.1% from April 2010 rather than staying unchanged (as the corresponding RPI was -1.4%).

- Many scheme booklets will have spoken in terms of RPI for revaluation and increases in payment. Communicating any change for the worse will not be easy. Taking the example of a pension deferred in January 1990, a CPI-linked pension would have risen by 66.8% to date whereas an RPI-linked pension would have increased by 87.1%. (However, going forward it is worth noting that the current 2.5% cap on statutory revaluation for benefits accrued from April 2009 may trump both inflation indices – as would have been the case if it had applied from 1990 in the above example.)

- Section 67 of the Pensions Act 1995 prevents an occupational scheme member's accrued rights from being reduced. This could force schemes to continue to use an RPI basis, but there is also an argument that if the scheme referenced increases and revaluation to statutory requirements, then a change in those requirements should not trigger section 67.

- In the short term, the gap between RPI and CPI is wide, so a pension in payment increase for 2011/12 will highlight the scheme member's 'loss' as a result of the change. RPI may well significantly outpace CPI in the next couple of years. The fact that the RPI takes account of mortgage interest costs, but the CPI does not means that as interest rates crawl off their all-time lows, RPI will reflect higher mortgage outlay, but CPI will not.

- CPI is open to criticism that its exclusion of housing costs means that council tax and property depreciation do not figure in the index. Neither can be dismissed as irrelevant to pensioners.

- Many defined benefit schemes have investment strategies such as liability driven investment (LDI) which are designed around RPI, not CPI. An RPI swap which was the perfect matching investment recently is now potentially a mis-match.

- There are no CPI-linked gilts: the £200bn+ index-linked gilts in issue are all driven by the RPI. Matching investments for CPI-linked liabilities are almost non-existent.

CHANGE IN THE NORMAL MINIMUM PENSION AGE

HMRC to remove unauthorised payment charges where a member transfers crystallised benefits between ages 50 and 55

In our April 2010 bulletin we set out the potential unauthorised payment charges that could arise as a result of the change in the normal minimum pension age from 50 to 55. One of these related to an individual who had commenced drawdown payments prior to 6 April 2010, when he was aged over 50 but less than 55, who wished to transfer his benefits to a new scheme prior to age 55.

HMRC had initially indicated that such a transfer would be subject to unauthorised payment charges, even if it otherwise complied with the requirements of the Transfer of Sums and Assets Regulations. However, in response to representations by the industry and as a result of further legal advice it later confirmed that no such charges would apply. Despite this, HMRC continued to indicate that any income payments taken by the member from the receiving scheme before his 55th birthday would be taxed as unauthorised payments. The Government has now indicated that it intends to bring forward regulations to remove the unauthorised payments tax charge on such income payments made between the member's 50th and 55th birthdays, and to backdate these regulations to cover transfers made on or after 6 April 2010.

The proposed regulations will apply to an individual who is aged 50 and over, but under 55, and who has already satisfied the normal minimum pension age test of 50 and over prior to 6 April 2010. The regulations will apply where:

- sums and assets of an income drawdown fund are transferred to a new income drawdown fund with another provider; or

- sums and assets underpinning an existing lifetime annuity are transferred to another provider to provide a new lifetime annuity; or

- sums and assets underpinning an existing short-term annuity are transferred to another provider to provide a new short-term annuity; or

- sums and assets underpinning an existing scheme pension are transferred to another registered pension scheme to provide a new scheme pension.

The regulations will ensure that there will be no unauthorised payment tax charge on these sums and assets and any payments of pension after the transfer.

Where, in advance of the regulations being made, scheme administrators act in accordance with this announcement, neither they nor members will need to pay the additional tax charges for failing to operate in accordance with the existing legislation.

COMMENT

It is to be welcomed that the Government is prepared to bring in amending legislation to address this clearly unintended consequence of the change in normal minimum pension age from 50 to 55. It is a shame that it has not also sought to address the unauthorised payments charge that will arise where an individual in drawdown decides, between ages 50 and 55, to secure a lifetime annuity or a scheme pension.

NATIONAL MINIMUM WAGE

The national minimum wage (NMW) is the minimum amount defined by law that an employer must pay their workers. Rates are scheduled to rise from 1 October 2010 as follows:-

- The adult ("main") rate rises from £5.80 to £5.93 per hour for workers aged 21 years and over.

- The development rate rises from £4.83 to £4.92 per hour for workers aged 18 to 20 years inclusive.

- The rate for workers under age 18 who are no longer of compulsory school age rises from £3.57 to £3.64 per hour.

- A single apprentice minimum wage rate of £2.50 per hour will apply for apprentices currently exempt from the NMW.

INCOME WITHDRAWAL RATE FOR AUGUST 2010

The appropriate gilt yield, used to determine the "relevant annuity rate" from HMRC's tables for an adult member commencing income withdrawals (or reaching an income withdrawal review date), in August is 3.75%.