



The Pensions Revolution

Not So Simple Stupid

This year's Budget was received by the media as being a non-event with few surprises. In so far as pensions taxation is concerned nothing could be further from the truth. The new rules will create both winners and losers. For many younger people the changes will result in a simpler set of rules which will make future pensions provision easier.

For those who are already planning their retirement the new rules create opportunities for some and tax pitfalls for others. This newsletter explores some of the opportunities and threats which could now confront your retirement plans.

The legislation will not be implemented until April 2006. This gives a two year window in which to

take action to protect your fund. With appropriate advice you could blend the best of the old and new rules to maximise your retirement fund and claim the generous tax relief available.

LEBC's advisers have been immersed in the details of the changes and below we outline the likely scenarios certain clients could face. The rules, however, are complex and to obtain individual advice on how the changes will affect you and the action you can now take you should contact your usual adviser or e-mail us on: pensions@lebc-group.com.

Waiting until 2006 is not an option as failure to get advice now could seriously damage your wealth.

Are you happy to pay tax at 55%?

If your pension funds are in excess or near to £1.5 million on "A" day, 6th April 2006, you can take action to protect their value so that your funds will not be hit by the new recovery charge. However, establishing the value of your funds and what sort of protection you should opt for is not so simple.

Valuation of Funds

The table on the right shows how this works

The lifetime limit will increase each year so that by 2010 it will be £1.8million and will be reviewed thereafter. 25% of this can be taken as tax-free cash, the rest as taxable income. If in the year in which you take benefits from a pension plan the fund exceeds the limit the excess will be taxed at 25% if taken as income and at 55% if taken as a cash lump sum.

This tax charge can be avoided in two ways:

Primary Protection:

Only available if your fund at "A" Day exceeds the lifetime limit. This option allows you or your employer to continue to make contributions or to accrue additional benefits within certain limits.

Enhanced protection:

Is available regardless of fund size but means that you cannot add anything further to your funds. If you do the

Pension Type	Valuation basis
Personal Pension or retirement annuity	Monetary value of funds at 6.4.04.
Group Money Purchase Scheme	Monetary value of funds at 6.4.06. But subject to not exceeding current Inland Revenue maximum.
Defined Benefit Scheme (final salary scheme)	Pension accrued to date per annum multiplied by 20
Not yet drawn	
Defined benefit scheme in payment	Pension in payment per annum multiplied by 25
Unapproved benefits and state pension	Disregarded
Drawdown plan	25 times the maximum income allowed by the Government Actuary, regardless of actual withdrawals.

protection is lost. Under this option your fund will never be subject to the recovery charge regardless of its size.

There are therefore four options to consider:

- **Primary protection**
- **Enhanced protection**
- **Both**
- **None**

If you will be over 50 by April 2006 and have a sizeable fund there is also the option of taking benefits now under existing rules. For some members of occupational schemes it could be possible to take all benefits now as

a tax free lump sum. This amount won't count towards the £1.5 million which you can then build thereafter. Depending upon which protection option you choose there are restrictions which will apply to future fund growth or fund choices. It is therefore imperative that you review the protection options prior to 6th April 2006 and get your fund registered by 6th April 2009. Given the complexity of these matters and the option to move your funds prior to 5th April 2006 which may not be available after then it will be better to get advice sooner rather than later in order that you can make any changes necessary prior to the deadline. To explore which option is likely to suit you the best contact your usual LEBC adviser or e-mail us at pensions@lebc-group.com.

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Pension Sharing: Good News - Bad News

Clients and their advisers who are in the throes of matrimonial proceedings need to be aware that legislation contained in the Finance Bill will make it more difficult to give a fair valuation of pension scheme assets particularly where substantial assets are involved and where some of those benefits are derived from final salary occupational pension schemes.

From April 2006 the Government will impose a "recovery charge" on all pension funds where the notional value of these is in excess of £1.5 million. This limit is set to increase each year. It is also calculated differently from the cash equivalent transfer value (CETV) For matrimonial lawyers this means that valuing up pension scheme assets is no longer as simple as obtaining a (CETV) from the pension scheme Trustees.

The cash equivalent transfer value represents the Actuary's best guess of the value of the member's benefits making certain assumptions about fund growth, inflation and pay rises. This is commonly used as a starting point in matrimonial proceedings but will not take account of a recovery charge being levied upon the spouse if their cumulative pension benefits exceed the new lifetime limits.

What's more although this legislation does not take effect until April 2006, the effect of it is retrospective and will hit older divorcees and in particular those with occupational scheme benefits the hardest. The tax levied on the fund will be between 25% and 55% depending upon circumstances and therefore could substantially reduce the actual funds available to the pension scheme member in retirement.

A welcome change however is that pension assets given up as a result of a pension sharing order will no longer be counted as part of the member's pension funds.

Instead the ex spouse receiving the pension share will have them counted towards his or her lifetime limit. Simplistically it could be argued that pension sharing is now a better option for the pension rich spouse. However, without taking account of future recovery charges and how this compares with the CETV, anomalies could arise when assessing each party's financial means.

For those who have already suffered a pension debit on their funds the future timing of their retirement could seriously effect the level of pension they will be allowed to take. It is essential that clients and their advisers who are undergoing matrimonial proceedings are aware of the impact of these changes so that these can be taken into account in the negotiations between parties.

Whilst the Government's aim was to simplify pensions taxation legislation unfortunately the transitional rules which have been put into place actually complicate matters for anyone who has already built up a substantial pension. There are ways in which the severest impact of the new tax charge can be minimised but the individual member is not always totally in control of his or her scheme benefits in these circumstances and advice needs to be sought both from a point of view of minimising tax charges and also taking them into account in a fair manner when assets are to be divided between spouses. The changes proposed by the Government are radical and effectively remove 30 years of legislation and practice at a stroke and replace them with a whole new set of rules which will fundamentally alter the real value of benefits available to each party.

It is essential that advice is taken in this area from a pensions specialist who understands the impact of the new rules on the valuation of pension benefits.

Limitless Fun

A further point to remember is that although the lifetime limit is a personal limit applying to all your pensions, it is a test that you might have to pass more than once. If you have more than one pension you will need to pass the lifetime limit test each time you draw a new benefit. The following example illustrates this:-

Peter Lewis will be 60 in May 2006 when his occupational pension will pay him a pension of £70,000 per annum. His scheme Trustees value this on a 20:1 formula so that Peter's pension has a value of $20 \times £70,000 = £1,400,000$. The pension increases at 3% per annum. This figure is £100,000 below the limit so no recovery charge is levied.

When he is 65, Peter has another pension from a previous job which will pay him £15,000 per year. The Trustees of this scheme value up the pension on a 20 x £15,000 = £300,000 basis. The first pension is now £81,149 per annum and must now be valued at 25 x.

So Peter's total pensions are:-

20 x £15,000 = £300,000
25 x £81,149 = £2,028,729

Total : £2,328,729

At this stage the lifetime limit is £1.8 million which means Peter has a recovery charge of 55% on £528,729. The Trustees of the second scheme will therefore need to deduct £290,800 from the benefits and pay this to the Inland Revenue.

Where an individual has more than one pension scheme it is important to ensure that Trustees of each scheme are fully aware of all the benefits both those which have been drawn in the past and those which are likely to be drawn in the future. This can be demonstrated from the above case, members of schemes should not rely upon the Trustees of the scheme to advise them whether they are under or over the limit as the addition of other benefits can alter this position quite fundamentally. If Peter registered his funds for enhanced protection he could avoid this tax charge. For an independent audit of your benefits and how they are likely to be affected by these new charges contact your usual LEBC consultant or e-mail us on pensions@lebc-group.com.

Better Death Benefits

- Death benefits paid out under pension schemes will be more generous from 2006 onwards. The lifetime limit i.e. £1.5 million can be paid to dependent's in the form of a lump sum and income. This is more generous than the current limits which relate to the benefits to service and salary and for most pension scheme members restrict benefits to 4 x earnings, or the earnings cap, depending on scheme, payable as a lump sum.

- Group death in service schemes will therefore be able to provide much better benefits particularly to lower paid members and given that this is a tax-free benefit in terms of the cost to the employee, it is one of the most cost effective benefits which an employer can provide. We therefore expect to see a growth in these schemes and their popularity amongst both employers and employees as a means of companies providing generous benefits on a tax efficient and low cost basis to their staff and their families.

Want to buy your home in the sun?

From 2006 it will be possible to use pension schemes to buy residential property. This includes property which you may use yourself. The monies used will be boosted by the tax relief available to pension schemes. While your main residence could be included it is an option which, for tax reasons, is likely to be attractive only in exceptional circumstances. However, a holiday home which you only use personally on occasion could be bought by your pension scheme and would offer the following benefits:-

- Tax relief on the contributions paid into the pension at your highest marginal rate.
- If funded by your employer no income tax or national insurance to pay on contributions of up to £215,000 per annum.
- Corporation tax relief for your employer.
- No capital gains tax on the sale of the property at a profit.
- If let out for part of the time to paying guests no income tax to pay on the rent received.

You must however, either pay a commercial rent to your pension fund when using the property yourself or suffer a benefit in kind income tax charge for the cost of your stay. Remember the rent will be paid into your own pension fund. If you already own a second home it can be bought by your pension scheme after 2006 but must be at an open market value. The transfer of the asset may, however, trigger a charge to capital gains tax here and also local gains tax if it has already gone up in value.

Consider the following possibilities:-

Fred Jones a client of LEBC Group owns FJ Engineering Ltd a successful business making air conditioning equipment. Fred employed his wife Joan for two months to cover for his absent secretary. He pays Joan £250 per week. The company have had a good year and have excess profits so FJ Engineering pays £215,000 into a pension for Joan. Joan invests the pension scheme funds in a house in France. There is no tax or national insurance to pay on this. The company will get corporation tax relief on the pension contribution.

Funding Student Accommodation

The following year their son Steve returns from his gap year and works in the factory prior to going to Durham University. FJ Engineering pay Steve £5 per hour. Steve needs somewhere to live in Durham.

FJ Engineering pay £225,000 into a pension for Steve tax and national insurance free. Steve invests his pension fund in a house in Durham which he shares with two

other students. All three students, including Steve pay rent to the pension fund. There is no tax to pay on FJ's contribution or on the rental income received from his friends. If Steve sells the house there will be no capital gains tax to pay on any increase in its value. Steve is well on the way to securing his retirement income even before his career has started.

Funding the main residence purchase

Their older daughter Melanie is now married to John and they want to move to a bigger house but are finding it hard to get a big enough mortgage. Melanie works part time at FJ Engineering following the birth of their second child. Melanie's salary is £10,000 per annum and John's is £50,000 so their maximum mortgage is £180,000. They really need £280,000 to buy Rose Cottage the home of their dreams at a purchase of £500,000. Once again FJ Engineering has had a good year so it pays £104,000 into Melanie's pension. She uses this to buy part of their home on a tenants in common basis with the pension scheme owning 20%, Melanie 40% and John 40%.

There is no tax or national insurance for Melanie to pay on the company's pension contribution. The company will get corporation tax relief on the payment. Melanie and John could pay rent to the pension scheme on 20% of the normal rental value or Melanie could suffer a benefit in kind tax charge on the value of 20% of the market rent. They can now afford the house they want and are also able to reinvest the rent for Melanie's retirement.

None of the above is possible now due to existing Inland Revenue restrictions on pension contributions which are linked to salary and service within the firm. From 6th April 2006 all these restrictions will go.

Pension scheme investment in property is currently restricted to commercial property and third party transactions (property can be bought from an employing company and used for the business but not for the benefit of individual employees).

Now is the time to start funding to build up funds under the current rules which are particularly generous for long serving employees and for the self employed who have fluctuating earnings and can use earlier good years to fund current years contributions. By building up funds now you will be in a better position after April 2006 to take advantage of the new opportunities which wider investment potential will allow.

Gearing Up To New Investment Opportunities

From April 2006 pension schemes will have more freedom to invest in a wider class of assets including residential property, works of art, fine wines and classic cars. Race horses are unlikely to be permitted as they are usually a depreciating asset. Commercial property would also remain a permitted asset. In order to take advantage of this liberalisation individuals need to first build up their pension schemes in order to have funds to purchase that item. At present this can be achieved in two ways; contributions made by the employer or the member and borrowing, both these features will continue under the new regime. While contributions will be higher, limits on borrowing will be less generous in future. The box below explains this.

Pre 2006	Type of Scheme	Borrowing Limits
	Personal Pensions	75% of property value
	Occupational Schemes	45% of scheme assets plus 300% of annual contributions
Post 2006	Type of Scheme	Borrowing Limits
	All Schemes	50% of schemes assets

It is also possible for companies to loan back monies from their pension schemes and to help finance capital projects in this way. Whilst these loans have to be on a commercial basis the current rules are more flexible than the proposed new rules. For example, currently loans can run up to the members retirement age whereas in future they will be restricted to five years and to no more than 50% of the scheme assets. Loans in future will have to be secured, at present they can be on an unsecured basis. Such loans can be attractive as essentially the interest paid is in fact being paid to your own pension fund rather than to a third party lender. Those who wish to use their pension schemes to invest in commercial or residential property therefore need to build up their fund now. Where commercial property is the objective it may be advantageous to get borrowing in place now under existing and more generous rules so that existing loans can continue after 2006 under transitional arrangements.

It is also possible to gear up property purchase to a greater extent by using a combination of occupational and personal pensions and different borrowing limits which apply. As with any investments it is essential that income produced by the asset will be sufficient to maintain loan repayments which must be on a fully commercial basis. Scheme members' must also avoid deriving any benefit from the scheme asset unless this is paid for on a fully commercial basis. Failing to do so will result in a 40% benefit in kind charge. If the scheme asset concerned exceeds more than 25% of the scheme assets this income tax charge goes up to 55%, in other words, if your scheme invests in fine wine and you drink it you won't just have a headache to worry about.

To find out what the possibilities for property or other alternative investments are for you talk to your usual LEBC contact or get in touch via pensions@lebc-group.com.



More Freedom for 75 Year Olds

Pension scheme rules at present allow members to draw their income directly from the fund up until age 75 at which point an annuity must be bought. Many individuals object to this rule as they feel that they are forced to hand over their entire remaining pension fund to an insurance company and will not necessarily get the full benefit of this unless they live to a good old age.

If this reflects your views you will be pleased to know that the Government has relaxed the rules relating to annuity purchase post age 75.

After this age it will be possible to continue to draw down income directly from your fund. However the maximum which can be drawn each year in this way will be the equivalent of 70% of the open market annuity income for a single person at age 75.

This age will not be reviewed even when you are well into your 80's or 90's so that over time the value of the benefit to those who do live to be a great age could be somewhat diminished.

In the event of your death arising before all funds are exhausted then there can be no payment of any funds to any member of your family or other beneficiary. Where funds are still available these can either be paid to a charity or reallocated within the scheme to other members. This latter option will be particularly useful for those benefits arising from schemes run by family businesses where more than one family member is a member. In this way it will be possible for funds to trickle down from one generation to another without apparently any charge to inheritance tax or the normal 35% tax charge that would arise on death before age 75. The big disadvantage of the new arrangements is the limitation on maximum income which is unlikely to be attractive particularly as the years go by.

If you are particularly concerned not to buy an annuity at retirement and are able to retire within the next 2 years then there are other alternatives available before then which will enable you to preserve the value of your fund and to take an income from it during your lifetime with the fund then forming part of your estate and being

subject to the usual inheritance tax charges. Whether annuity purchase is a bad thing or not needs to be explored for whilst there is the obvious philosophical objection to your fund disappearing into the coffers of an insurance company it does not necessarily have to be arranged in this way.

In particular, it is possible to provide for dependents benefits and guarantee periods to ensure that the funds continue to be paid as long as possible to other family members. Additionally insurance companies will be able to make a cash refund to those annuitants who die young and have not got back 100% of their investment, this will be subject to a 35% tax charge but is more flexible than current rules allow. One of the big benefits of an annuity purchase is it does give a guaranteed level of income which will last as long as you do.

Individuals who are contemplating retirement at present should consider all the options prior to making a decision and should take account of both the existing rules and the likely changes.

Trustees Beware

Pension scheme Trustees running occupational scheme benefits need to be aware of the need to amend their rules to fit in with the new legislation in the Finance Bill. At the same time important changes are included in the Pensions Bill and these also need to be incorporated:-

- It will no longer be possible for schemes to opt out of member trustee election.
- Trustees must demonstrate a higher level of knowledge than at present.
- The scheme rules and documents will need to show the new limits and allowances.
- All benefits bought for members of occupational pension schemes with less than 50 members must be secured by annuity purchase. The member must also be offered an open market option.
- Schemes must provide more comprehensive and regular information to scheme members. An allowance of £150 per member for professional advice will be introduced without a benefit in kind charge applying and this will also qualify for corporation tax relief.

- Scheme trustees will also have to administer and collect the recovery charge where the lifetime limit is exceeded.

If you have members earning in excess of the earnings cap (£102,000 for 2004/2005) remember this will be abolished in 2006. So you might need to revisit definitions of salary and pension benefits and contracts of employment. Alternatively you will need to fund for the consequent additional benefits which will accrue to those individuals.

LEBC Group Ltd., with its expertise in pension scheme issues is able to help Trustees come to terms with these changes and to give individual advice to scheme members.

If you would like us to give your scheme rules and documents a make over in the light of the Pensions Bill and Finance Bill then please contact your usual LEBC adviser or e-mail us on pensions@lebc-group.com.

Nothing Ventured

- The Finance Bill also doubles the income tax relief on venture capital trust investments from 20% to 40% for investments made in the next 2 tax years. Those likely to be impeded by the pensions lifetime limit of £1.5 million on their funds may therefore wish to consider supplementing their retirement planning via a venture capital trust. Such arrangements however are not suitable for everyone as they entail a very high level of risk and should only be entered into with proper professional advice.

If you would like to explore the possibility of adding these to your portfolio we would be pleased to provide further information and individual advice on them.

For further information on any of the articles appearing in this issue of 'intouch' either return the reply card or email us at: pensions@lebc-group.com

