

## PENSION PLANNING – THE BASICS

### Introduction

These notes are intended as a general guide to the advantages of funding a pension scheme based largely on the new rules introduced on 6<sup>th</sup> April 2006 (“A” day). These notes are not exhaustive and no action should be taken or not taken solely as a result of these notes and professional advice should always be sought.

### Contributions

From “A” day the current regime was replaced by a more simplified and generous regime.

### Employer Contributions

For each employee an employer will be able to contribute up to the “annual allowance” almost regardless of the employee’s age or level of pensionable earnings. However the company’s Inspector of Taxes will need to be satisfied that any pension contribution forms part of a reasonable commercial remuneration package for that individual before allowing the contribution as a business expense.

The annual allowance for 2008/09 is £235,000 rising to £255,000 for 2010/11. Beyond that, we expect the annual allowance to increase by the Retail Price Index.

### Personal Contributions

Whether the individual is employed or self employed their maximum level of contribution is 100% of pensionable earnings. For employees, their contribution, in aggregate with any employer contribution must not exceed the annual allowance. Personal contributions will be tested against earnings in the tax year that the contribution is paid.

Pensionable earnings do not include dividends.

### Investment Growth

Monies within a pension scheme grow free of almost all taxation. The only tax that is levied on income and capital growth is the tax credit withheld on dividends from UK equities. Any tax withheld overseas is not reclaimable.

### The Lifetime Allowance

The Government have sought to impose a limit on the size of accrued pension funds per individual that will qualify for exemption from tax. This is known as the lifetime

allowance and for 2008/09 it is £1.65 million rising to £1.8 million for 2010/11 with further, as yet unspecified, increases thereafter.

An individual's cumulative pension funds are tested at the point of first drawing pension benefits against the lifetime allowance. Any funds in excess of the then lifetime allowance are taxed at 55% with the balance available to the member as a lump sum. It is possible to register for 'protection' at A day, funds already in excess of the lifetime allowance or those that may exceed it by retirement.

### Death Before Vesting

If, unfortunately, you should die before drawing any benefits out of your accumulated pension funds then the entire fund (up to the then lifetime allowance) is available to your nominated beneficiaries as a tax free lump sum outside of your estate for Inheritance Tax. Funds in excess of the lifetime allowance are not taxed at 55% but are available to purchase one or more dependant's pensions which will then be taxed in their hands as earned income.

### Drawing Benefits

You can access your pension funds from age 50 onwards without the need to retire. However, the minimum age will rise to 55 with effect from 6<sup>th</sup> April 2010.

If you have several pension arrangements they can be matured at different times rather than altogether.

### Tax Free Cash

You can take up to 25% of your fund as a tax free lump sum subject to your fund not then exceeding the lifetime allowance.

### Drawing a Pension

The balance of the funds, after tax free cash, must be used to provide you with a pension which is an income, capable of being paid for life and taxed as earned income at your marginal rate. There are two ways of securing this pension income, annuity purchase or Pension Fund Withdrawal (PFW).

### Annuity Purchase

The purchase of an annuity is the irrevocable spending of the capital on a policy with an insurance company that will pay a pension for the rest of your life or, potentially, until the second death of you and your spouse. Annuity purchase is generally recommended where the funds available after tax-free cash are less than £150,000 and where the pension represents the bulk of an individual's retirement income.

## Pension Fund Withdrawal

PFW is a mechanism whereby an individual can enjoy the benefit of their pension but without having spent their capital on an annuity. Think of your pension fund as a tank of water fed at the top by investment income and capital growth of the assets of your pension fund. At the bottom, there is a tap distributing that fund in the form of a pension to you. The level in the tank will be dependent both upon the investment growth enjoyed by the assets and the rate you are withdrawing your pension from the tank. The rate at which you can withdraw your pension is calculated by reference to Government Actuarial Department Tables (the GAD rates) which are regularly reviewed. GAD rates will generally mirror annuity rates which can fluctuate and, also, because we can give no guarantees as to future rates of investment return we cannot guarantee that the level of pension being withdrawn will never go down. Either falling annuity rates or poor investment performance, or a combination of the two may require a reduction in the rate of PFW in the future.

Clearly therefore, PFW is a higher risk retirement strategy compared to annuity purchase and should only be considered by individuals who have accumulated sizeable pension funds and sufficient personal wealth such that their pension does not form the bulk of their income in retirement. However, many people choose to go down the PFW route due to how their residual pension funds can be distributed upon their death.

### Death whilst in PFW

Death whilst in PFW will see residual funds left in the member's pension scheme. What happens to that money is governed by Inland Revenue Rules dependent upon the age and marital status of the member at time of death.

### Death before Age 75

If the deceased member leaves a spouse he or she has three choices as to what to do with the remaining fund;

- Purchase a dependant's annuity or
- Draw a widow's/widower's pension out of the fund or
- Pay 35% of the fund as a tax charge to the Inland Revenue and take the remaining 65% of the fund as a lump sum.

If there was no surviving spouse then it is the 35% tax charge with the remaining fund going to the deceased member's estate or their pre-nominated beneficiaries.

### Death after age 75

Whilst the new post "A" day rules have only been with us a few months, Gordon Brown, in his pre-budget statement in December 2006 announced changes to the rules governing residual pension funds left by a member who died after age 75.

These rules are designed to discourage the continuation of PFW post age 75 in favour of annuity purchase as the Government are now saying that they only intended for PFW post age 75 to be accessed by those who have a strong religious objection to the concept of annuitisation. Whilst yet another Government U-turn in pensions legislation is disappointing, PFW post age 75 will still be attractive to some people.

Upon the death of the member post 75 the options are now as follows:

- If there is a surviving spouse he or she can use the residual funds to purchase an annuity or continue with PFW (the option to take a tax-free lump sum less tax is no longer available).

If there is no surviving spouse (or, upon the eventual death of the surviving spouse) the funds can be left to a nominated charity with no tax consequences. The option of leaving monies in the scheme to be re-distributed amongst the other scheme members has been withdrawn.

If the money is not gifted to charity then various tax charges will apply which will mean that, for most people, their residual fund will suffer a tax charge of 70%. The balance of the fund will then be distributed to nominated beneficiaries but will be treated as a distribution from the member's estate and therefore, potentially, subject also to Inheritance Tax. This could mean that the total rate of tax on the funds left in the scheme after the member's death could be as high as 82%.

Whilst this tax charge is clearly designed to discourage PFW post age 75 some clients will still opt to go down that route, either because they want the residual funds to go to charity or they are pursuing an aggressive rate of PFW in an attempt to exhaust their pension fund before death.

### Summary

Post 'A' day, the benefits of funding a pension scheme can be summarised as follows;

- More generous contribution limits;
- Employer contributions no longer linked to pensionable earnings (this means directors can draw a very low salary in favour of dividends to reduce the National Insurance burden, whilst still being able to benefit from large company pension contributions);
- For most people, death before drawing benefits will see all of their fund paid out as a tax-free lump sum;
- No need to retire to draw pension benefits;
- 25% of the fund available as tax-free cash;
- Within limits, vary the amount of pension that can be withdrawn each year.
- No strict requirement to purchase an annuity by age 75.