Budget 2004

Inland Revenue

REV BN 39

17 March 2004

SIMPLIFICATION OF THE TAXATION OF PENSIONS

Who is likely to be affected?

1. Pension scheme savers in occupational and personal pension schemes, employers, the pensions industry, and Independent Financial Advisers.

General description of the measure

2. Simplification will replace the eight existing tax regimes with a single universal regime for tax-privileged pension savings. The numerous controls in the current regimes will be replaced by 2 key controls in the new regime. These will be:

- the lifetime allowance; and
- the annual allowance.

3. Additionally, the other main changes are:

- there will be a single set of rules on pensions in payment allowing all schemes the ability to offer members a tax free lump sum of up to 25% of their pension fund;
- Occupational pension schemes will have the opportunity to offer flexible retirement if they wish. This will enable people in occupational pension schemes to draw retirement benefits while continuing to work for the same employer;
- there will be a single set of investment rules for all pension schemes. Subject to Department for Work and Pensions (DWP) requirements, pension schemes will be allowed to invest in all types of investments, including residential property; and
- the complex approval process for pension schemes will be replaced by a simplified regime requiring registration only.

Operative date

4. 6 April 2006.

Current law and proposed revisions

5. There are currently eight different tax regimes governing pensions, each with its own complex rules limiting the amount an individual can contribute to a pension scheme and the consequent benefits a scheme can pay out. This has led to anomalies between Defined Benefit (DB) and Defined Contribution (DC) schemes in the level of contributions that can be made and what benefits can be taken.

6. Contributions are currently subject to an earnings cap (£99,000 in 2003-04). However, current schemes allow different levels of contribution. For example:

- occupational schemes (1989 regime): employees may contribute, with tax relief, up to 15% of earnings up to the earnings cap. Employer contributions are limited to the earnings cap; yet
- personal pension plans (1988 regime): individuals may receive tax relief on contributions up to the higher of £3,600 a year or a percentage of capped earnings, the percentage varies on age.
- Even then, different rules apply to pre-1970 schemes, post-1970 schemes, 1987 regime, and Retirement Annuity Contracts. Members of Retirement Annuity Contracts also have the facility to carry forward and carry back unused relief from year to year.

7. These regimes also have different rules regarding what benefits can be paid out to members. Members in a 1989 occupational scheme are limited to two thirds of final earnings up to the earnings cap after 20 years' service, but there are no limits on the size of pension benefits for people in personal pensions. There are also different rules governing the amount of tax-free lump sums that different schemes can pay.

8. Under simplification all these controls will be removed. In their place will be a single set of rules that will apply to all tax registered pension schemes. Benefits that schemes pay out will be decided by scheme design and not by Revenue regulations.

9. The key elements of the simplified regime will be:

- A single lifetime allowance on the amount of pension savings that can benefit from tax relief**.** The value of the lifetime allowance will be set at £1.5m on introduction rising as follows:

  2007 - £1.6m
  2008 - £1.65m
  2009 - £1.75m
  2010 - £ 1.8m

The lifetime allowance will be reviewed quinquennially.

- An annual allowance initially set at £215,000. It will increase steadily each year such that in 2010 it will be at £255,000 for contributions to DC schemes or

increases in accrued benefits in DB schemes. The level of the annual allowance will be reviewed quinquennially.

- Contributions will no longer be limited to a fraction of capped earnings. Individuals will be able to make unlimited contributions and tax relief will be given on the higher of 100% of relevant earnings or, where the individual contributes to a scheme that operates relief at source, £3,600.

- All Schemes will be able to pay tax-free lump sums of up to 25% of the value of the pension rights. The maximum permissible tax-free lump sum rises, under simplification, to 25% of lifetime allowance.

- A lifetime allowance charge of 25% on funds in excess of the lifetime allowance. Funds in excess of the lifetime allowance may be taken as a lump sum, in which case the lifetime allowance charge will be at a rate of 55%.

- An annual allowance charge of 40% on contributions or increases in excess of the annual allowance.

- In order to value the capital worth of defined benefits for the purpose of the lifetime allowance, there will be a single valuation factor of 20:1. Individuals who receive payment of a pension at 5 April 2006 will be treated as having used up part of their lifetime allowance if, after 5 April 2006, they receive payment of a new benefit. The factor for valuing such pensions will be 25:1, which reflects the fact that people will generally have taken tax-free lump sums.

- A valuation factor of 10:1 will be used to measure the annual increase for the purpose of the annual allowance.

- Transitional arrangements will protect pension rights built up before 6 April 2006. There will also be protection for rights to lump sum payments that exist at 6 April 2006. There will be two options for transitional protection from the lifetime allowance charge:

  - **Primary Protection** which will be given to the value of the pre-April 2006 pension rights and benefits in excess of £1.5 million; or
  - **Enhanced Protection** which will be available to individuals who cease active membership of approved pension schemes by 6 April 2006. Provided that they do not resume active membership in any registered scheme, all benefits coming into payment after 5 April 2006 normally will be exempt from the lifetime allowance charge.

- The minimum pension age will rise from 50 to 55 by 2010. Those with certain existing contractual rights to draw a pension earlier may have that right protected. There will be special protection for members of those approved schemes in existence before April 2006 with low normal retirement ages, such as those for sports people.

- It will no longer be necessary for a member to leave employment in order to access an employer's occupational pension. Members of occupational pension schemes may, where the scheme rules allow it, continue working for the same employer whilst drawing retirement benefits.

- Employers will continue to be able claim a deduction in computing profits chargeable to UK tax for employer contributions paid to a registered pension scheme. The Government intends to continue the current practice of spreading large contributions over 2 to 4 years.

- It will continue to be a requirement that pensions are secured by age 75. However, pension income may be delivered after age 75 through Alternatively Secured Income, an alternative method to provide benefits via an income for life which may be used by those with principled objections to the pooling of mortality risk.

- Death benefits from a scheme can be in the form of either a lump sum, a pension to one or more dependants or a combination of lump sum and pension. This will depend on whether the benefit is in payment at the time of the member's death and the age of the member at death.

- There will be new, simpler processes for scheme registration and reporting. The current limits on what a scheme may invest in will be lifted and replaced by a single set of investment rules for all pension schemes.

- Non-registered pension schemes may continue in the new regime, but without any tax advantages. They will be treated like any other arrangement to provide benefits for employees. Amounts in non-registered pension schemes will not be tested against the lifetime allowance and the lifetime allowance charge will not apply to them. Transitional protection will be available for pension rights accrued at 6 April 2006 within non registered schemes.

Further advice

10. If you have any questions about this change, please contact the helpline on 0115 974 1600

www.inlandrevenue.gov.uk