

Introduction

Since 6 April 2006 (known as 'A day') all pension schemes have been governed by a single set of tax rules that were intended to simplify the legislation. However, since the legislation has been introduced there have been endless changes and amendments, most recently the reduction in contribution and benefit allowances which have been accompanied by greater flexibility in how benefits may be taken. This chapter sets out the general tax rules that apply to all registered pension schemes.

General rules

Lifetime allowance

The standard lifetime allowance is the maximum permitted tax-privileged fund that an individual can normally build up during their lifetime to provide retirement benefits. In normal circumstances funds above this limit will be subject to tax penalties. The initial standard lifetime allowance limit was set at £1.5 million in 2006/07 tax year and it has increased incrementally each year to its current level of £1.8 million. The lifetime allowance will generally reduce from 6 April 2012 to £1.5 million although subject to certain conditions that will prevent further benefit accrual it will be possible to claim 'fixed protection' at the higher figure of £1.8 million. The Treasury will set the limit for future years. Under current legislation, the lifetime allowance cannot be reduced, so any lowering of the limit would need to be effected by a change in legislation.

When benefits are taken under a registered pension scheme, the member's available lifetime allowance is reduced by the value of the benefit being taken. Where no available lifetime allowance remains, the tax penalties will be applied to any excess amount. The level of penalty depends on how the benefit is paid as follows:

- Where benefits are paid as a lump sum the excess amount (lifetime allowance excess lump sum) would be subject to an immediate 55% tax charge.
- Where benefits are paid as an income, an immediate 25% tax charge would apply and the resulting pension income would also be liable to income tax on the member.

Where benefits are paid during the member's lifetime, the member and scheme administrator are jointly and severally liable for payment of any excess charge. If benefits are paid after the member's death, then the recipient of the benefit is fully liable for any tax due.

Transitional protection

Some protection was available for those with benefits accrued before 6 April 2006 in the form of transitional protection. If the value of a person's benefits and rights on 5 April 2006 exceeded £1.5 million, they had until 5 April 2009 to register their rights with HM Revenue & Customs (HMRC), although in practice a decision often needed to have been made before A Day. Such rights could be protected in two ways:

- *Primary protection* The value of pre-A Day rights is increased in line with the rise in the standard lifetime allowance. Any excess over this amount at the time of drawing benefits suffers the lifetime allowance charge.
- *Enhanced protection* The individual must have ceased active membership of all their pension arrangements before A Day (although it may be possible in limited circumstances to accrue benefits under a defined benefit scheme if salary growth is low). All benefits are then free from any lifetime allowance charge. If this option is chosen, it is also possible to elect for primary protection, although enhanced protection takes precedence. Primary protection would only come into play if the member lost their right to enhanced protection.

Enhanced protection can be lost in a number of ways, for example by making any pension contribution to a defined contribution scheme, however small, or by the setting up of a new arrangement other than for the purposes of accepting a recognised transfer payment. Enhanced protection can also be revoked by submitting a written election to HMRC.

In practice, it is hard to see why anyone who had decided not to add to their pensions savings after 5 April 2006 would have initially chosen primary protection.

Example 14.1 – Self administered schemes

On 5 April 2006, Julia was a member of a small self-administered scheme (SSAS) with a fund of £1.6 million. She registered this with HMRC and contributions to the scheme ceased. Five years later, when her fund is worth £3 million, she decides to draw her retirement benefits. The standard lifetime allowance at that time has risen by 20% to £1.8 million.

If she had chosen primary protection, she would be allowed to draw benefits up to a value of £1.92 million (£1.6 million × 120%) without any lifetime allowance charge. The balance of £1.08 million is subject to a lifetime allowance charge before any benefits are taken.

But if she had chosen enhanced protection, she would be allowed to use all £3 million to provide benefits without any lifetime allowance charge.

An enhanced protection election was also possible if the value of benefits on 5 April 2006 was less than £1.5 million.

The reduction of the standard lifetime allowance to £1.5 million from 6 April 2012 will not impact these protections. Primary protection enhancement factors will be based on whichever is the higher of the standard lifetime allowance and £1.8 million and enhanced protection will continue to apply to the whole value of the member's benefits.

A new protection will be available from 6 April 2012 for those who have neither primary nor enhanced protection, but who wish to have their benefits tested against the greater of the standard lifetime allowance and £1.8 million. However, the protection will only remain in place if, after 5 April 2012:

- The member does not accrue any further benefits under registered pension schemes;
- There are no impermissible or non-permitted transfers in relation to the member; and
- No new arrangements are set up for the member other than in permitted circumstances.

There is also transitional protection for certain tax-free cash entitlements built up before 6 April 2006. This is discussed in the tax-free cash section below.

Benefit crystallisation events (BCE)

There are various occasions when an individual's pension benefits must be tested against, and will use up part of, their lifetime allowance. Any excess over the lifetime allowance would be liable to tax penalties as outlined above. There are ten BCEs:

1. When funds are designated to provide an unsecured pension.
2. Where a member becomes entitled to a scheme pension.
3. Excessive increase to a scheme pension.
4. Purchase of a lifetime annuity.

5. Defined benefit test at age 75.
- 5A. The individual reaching the age of 75 having designated sums or assets held for the purposes of a money purchase arrangement under any of the relevant pension schemes as available for the payment of drawdown pension to the individual.
- 5B. The individual reaching the age of 75 when there is a money purchase arrangement relating to the individual under any of the relevant pension schemes.
6. Where the member becomes entitled to a relevant lump sum payment (pension commencement lump sum (tax-free cash), serious ill health and lifetime allowance excess lump sum).
7. Payment of a lump sum death benefit.
8. Transfer of benefits to a qualifying recognised overseas pension scheme (a transfer to a non qualifying scheme is treated as an unauthorised payment and taxed accordingly).
9. Any event prescribed in regulations as being a crystallisation event.

Unauthorised payments

Where a scheme makes an unauthorised member payment, the member (or, where the member has died, the recipient of the benefit) will incur a tax charge. Where the scheme makes an unauthorised employer payment, the sponsoring employer will incur a tax charge. In addition, the scheme administrator may face a scheme sanction charge. The scheme administrator can (and normally will) take the cost of the scheme sanction charge from the benefit being paid. Unauthorised payments are defined as anything that is not defined as an authorised payment under the terms of the Finance Act 2004. The charges that would apply are:

- Tax charge(s) on member or employer:
 - Unauthorised payments charge – 40% of the value of the payment.
 - Unauthorised payments surcharge – 15% of the value of the payment, where the value of the unauthorised payment is 25% or more of the value of the member’s fund value (unauthorised member payment) or pension scheme assets (unauthorised employer payment).
- Tax charge on scheme administrator:
 - Scheme sanction charge – 40% of the scheme’s total chargeable payments. However, if the unauthorised payments charge has been paid, the scheme sanction charge can be reduced by the lesser of:
 - The amount of unauthorised payment charge that has been paid, and
 - 25% of the scheme chargeable payments on which the unauthorised payment charge due has been paid.

In practice, the scheme sanction charge is usually reduced to 15%.

Example 14.2 – Unauthorised payment charges

James has received an unauthorised payment from his pension scheme of £50,000. The value of his pension scheme prior to the payment being made was £150,000. The unauthorised payment charges would be as follows:

- Unauthorised payments charge – £50,000 @ 40% = £20,000.
- Unauthorised payments surcharge – £50,000 @ 15% = £7,500.

- Scheme sanction charge – £50,000 @ 15% = £7,500.
- Total tax chargeable is £35,000 or 70%.

Funding

As well as limiting the amount of tax-privileged funds that can be used at retirement to provide benefits, the way in which pensions can be funded changed dramatically under the post-A Day regime.

Annual allowance

The annual allowance is the maximum amount of tax-privileged savings that can be paid into a pension each year. The allowance is set at £50,000 in 2011/12 (having been £255,000 in 2010/11). The allowable contribution can be increased by carrying forward unused allowances from the previous three years during which the individual was a member of a registered pension scheme. The unused allowance is the amount by which the actual contribution paid in a year falls short of £50,000. The earliest year from which unused allowance can be carried forward to 2011/12 is 2008/09.

‘Savings’ in the case of a money purchase scheme are the aggregate contributions from member and employer (or self-employed member). If the individual is a member of a defined benefit scheme, the ‘contribution’ is derived from the adjusted increase in accrued benefit over a year multiplied by 16. So, if the adjusted increase in benefit is £5,000, the ‘contribution’ is £80,000. The adjustment refers to an allowance for inflation proofing (that reduces the figure) and for other transactions that are not contributions (such as transfers of rights).

Any payments in excess of the annual allowance are taxed at the member’s marginal rate of income tax through the self-assessment process (although the Government is planning to allow the tax to be collected from pension funds if the tax charge is at least £2,000).

The annual allowance is unlimited in the tax year in which the member dies or becomes unfit to work in any capacity or becomes entitled to the severe ill-health lump sum (implying that expectation of life is no more than 12 months).

Member contributions

The maximum gross member contribution that qualifies for income tax relief is the higher of £3,600 and 100% of their relevant UK earnings for that tax year. In order to qualify for tax relief, the member should be a relevant UK individual and be aged less than 75. Payments can be made in excess of the limit, but they will not qualify for tax relief.

Tax relief may be given in one of three ways depending on the type of scheme:

- *Net pay* – this only applies to occupational pension schemes. The employer deducts the pension contribution from gross pay so that full tax relief is provided immediately and no additional claim is required for higher rate tax.
- *Relief at source* – for contributions made to personal pensions (including self-invested personal pensions (SIPPs) and contract-based stakeholder pensions). Contributions are made net of basic rate tax and the product provider reclaims the basic rate tax from HMRC. Additional rate tax relief can be claimed via self-assessment or adjustment to tax code.
- *Individual claim* – typically for retirement annuity contracts where contributions are paid gross. Tax relief can be provided via self-assessment by increasing the basic rate tax threshold or adjusting the tax code for employees.

Although there is no upper limit on contributions made, any amount that exceeds the annual allowance, whether tax relieved or not will be subject to an annual allowance charge as detailed above.

Employer contributions

In theory, employers can make unlimited pension contributions on behalf of employees. However, in practice the amount paid will normally be restricted by how much the employer can afford to pay (and what is promised under the employment contract). The annual allowance may also result in the employer restricting the level of contribution made for an employee, in order that the employee does not end up with a tax charge to pay on the employer contribution.

Employer pension contributions no longer receive automatic tax relief, but are treated as an ordinary business expense and must meet HMRC requirements, including the 'wholly and exclusively test' to qualify for relief. Although no clear guidance has been given, the amount paid should be commensurate with the remuneration package of the individual and their contribution to the business. This aspect is likely to come under closer scrutiny where the member is a controlling director or connected party. If the Inspector of Taxes feels that there is a clear non-trade purpose then they can restrict or disallow any relief.

The amount of relief available will depend on the rate of corporation tax paid by the company, and tax relief on large pension contributions may be spread over two to four trading years depending on the amount of the contribution paid. The rules on spreading are applied separately to each registered pension scheme, therefore employer contributions paid to separate schemes are not aggregated. Generally the tax relief will be spread where the contribution exceeds 210% of the contributions made by the employer in the previous chargeable period, and the amount of relevant excess is £500,000 or more.

Pension input periods

The pension input period is the length of time used when testing a member's pension savings against the annual allowance. Each separate arrangement has its own input period that generally lasts for one year (or a year and a day for the first input period), and is not necessarily the same as the tax year.

The first input period for a pension arrangement begins when the first contribution is made (money purchase) or when benefits begin to accrue (defined benefit) and will end on the following 5 April unless the member chooses another date no later than 12 months following commencement. Where arrangements were already in force before 6 April 2006, the pension input period started (or will start) on the date of the first contribution or benefit accrual after that date. Subsequent pension input periods start immediately after the end of the previous period and run for a year although they can run for longer if the administrator or member wishes to align the input period with the tax year. The last pension input period automatically ends when the member either becomes entitled to all benefits or dies.

The pension input period can be changed by the scheme administrator for defined benefit schemes, and either by the scheme administrator or the member for money purchase arrangements. The new date is referred to as the nominated date, and this can be the current date, some time in the future or in the past. The only restriction is that a pension arrangement can only have one pension input period ending in any tax year.

There are protections in place for members whose pension input period straddled the 2010/11 and 2011/12 tax years and whose pensions savings before 14 October 2010 (the date the Government announced the planned reduction in the annual allowance) had already exceeded the new annual allowance level of £50,000.

In-specie pension contributions

The Finance Act 2004 introduced legislation that allows individuals to make pension contributions to registered pension schemes by transferring eligible shares. In the legislation these are defined

as shares acquired through a savings-related share option scheme. Although it is not specified in the legislation that assets other than eligible shares can be moved into a registered pension scheme in this way, HMRC have confirmed that all the law requires is that the contribution is expressed as a cash sum. Once the commitment to contribute the cash amount has been made, this creates a debt that can be cleared by transferring ownership of assets of equal value.

The cash value of the asset transferred will be defined as the market value at date of transfer. Unit trusts will be valued at the buying price, and stocks and shares listed on the LSE will be valued using the quarter-up method.

Tax relief will be available on the cash value of the contribution and will be subject to all the allowances and tax charges as detailed in this chapter for cash contributions. It is important to note that any transfer of ownership may trigger a charge to capital gains tax (CGT).

Third-party pension contributions

These are contributions made to a registered pension scheme for a member by someone other than the member or their employer (or former employer). The contribution could be made by an individual, a company or another legal entity such as a trust. For example, a grandparent could pay a contribution for a grandchild.

Contributions will be treated as if paid by the member themselves, are subject to the usual tax relief rules and limits and count towards the member's annual allowance. Where the contribution is made to a 'relief at source' scheme, it is paid net of basic rate tax, and the member can reclaim any higher rate tax due in the usual way.

Any third-party payments made in this way are treated as PETs for inheritance tax purposes, unless they are subject to an exemption, e.g. spousal exemption.

The fund

Contributions within a registered pension scheme grow free of UK tax on investment income and capital gains, although tax credits on UK dividends cannot be reclaimed. The income from foreign investments held within a registered pension scheme's underlying funds (for example, US shares) may be subject to a non-reclaimable withholding tax.

Death benefits

The maximum tax-efficient death benefit is a lump sum equal to the member's remaining lifetime allowance, i.e. currently £1.8 million if no pension benefits have been drawn at the date of death.

Any excess paid as a lump sum is subject to a 55% tax charge in the hands of the recipients. No such liability arises if the excess provides dependants' pensions. The lump sum benefits are normally free of inheritance tax (IHT) as long as they are distributed within two years of the earlier of:

1. The scheme administrator first becoming aware of the death, and
2. The day the scheme administrator could first reasonably have known of the death.

If a member has reached age 75 and dies and leaves 'uncrystallised funds', any lump sum payable from those funds will be subject to tax at 55%.

Retirement benefits

Normal minimum pension age

The normal minimum age for drawing benefits increased from 50 to 55 from 6 April 2010. There are some exceptions to the 55 age limit for some individuals as follows:

- They were an occupational pension scheme member who had a contractual right to retire before age 55 that was in existence before 10 December 2003.
- They were a member of a statutory scheme (for example, a civil servant) and were given a contractual right before A Day to retire before 55.
- They joined an occupational pension scheme between 10 December 2003 and 5 April 2006, and it was normal practice before 10 December 2003 for employees in the scheme to be able to retire before age 55.
- They were a member of a personal pension scheme or had a retirement annuity contract with a low pension age (for example, a sports person). However, early retirement options only apply in respect of pre-A Day plans and are subject to certain conditions, including a reduction in the amount of lifetime allowance available where the low retirement age is before age 50.

There is no maximum pension age (i.e. a date from which benefits must be taken), but there will be a test against the lifetime allowance at age 75 for money purchase schemes where the member is taking a drawdown pension or has not yet crystallised funds.

Tax-free cash

The maximum amount of tax-free cash (formally called 'pension commencement lump sum') that an individual can normally take when vesting benefits is 25% of the amount being crystallised, provided this amount does not exceed 25% of the individual's available standard lifetime allowance. The crystallised value for a money purchase scheme is straightforward because this is the value of the fund used to provide pension and tax-free cash. The calculation is more complex for defined benefit schemes: it takes into account the capital value of the pension and the scheme commutation rate.

There are some circumstances under which more than 25% of the fund can be paid as tax-free cash.

- The individual has registered a tax-free cash entitlement alongside primary protection, and the protected amount that can be taken is more than 25% of the fund.
- The individual has registered a tax-free cash entitlement alongside enhanced protection, and the percentage shown on the enhanced protection certificate is more than 25%.
- The individual has 'scheme-specific tax-free cash protection' – to have this they must have been a member of an occupational pension scheme before 6 April 2006 and have had a tax-free cash entitlement as at 5 April 2006 of more than 25% of their fund. The 5 April 2006 tax-free cash value increases in line with the increase in the standard lifetime allowance. On top of the protected amount of tax-free cash, the individual can take 25% tax-free cash from any post-A Day fund growth – this is taken as the fund value at the time benefits are taken, less the 5 April 2006 fund value increased in line with the standard lifetime allowance. Scheme-specific tax-free cash protection is not available if the individual has a registered entitlement to tax-free cash in conjunction with primary or enhanced protection.

Example 14.3 – Scheme-specific tax-free cash protection

On 5 April 2006, Jeremy had an EPP with a fund of £300,000, of which his tax-free cash entitlement was £100,000. He takes his benefits in June 2011, by which time the standard lifetime allowance has risen by 20% and his total fund is £500,000. Jeremy's tax-free cash entitlement would be calculated as:

Pre-A Day rights: £100,000 × 120%	£120,000
Post-A Day rights: (£500,000 – [£300,000 × 120%]) @ 25%	£35,000
Total tax-free cash	£155,000

There will be protection for those with scheme-specific tax-free cash protection from 6 April 2011, so that the 5 April 2006 tax-free cash value will increase in line with whichever is the higher of the standard lifetime allowance or £1.8 million.

Income in retirement

Any retirement income from a registered pension scheme is taxable as earned income. This means that pension income is not taxable at the 10% starting rate, which only applies to savings income falling within the £2,440 taxable band. Although pension benefits are taxed as earnings, there is no national insurance to pay on them, but neither do they count as relevant UK earnings. This means they cannot be used as an earnings basis for further pension contributions.

Retirement income can take one of four forms:

- *Scheme pensions* are the only pension payments that can be provided by defined benefits schemes. They can also be provided by money purchase schemes, but only where the member has been offered, and has refused, a lifetime annuity. A scheme pension can be provided directly from the resources of the pension scheme or can be secured by purchase of an annuity from a life assurance company (by the trustees). Death benefits after retirement can take the form of a survivor pension, a guaranteed payment period of up to ten years (measured from the date the member's pension started) or a pension protection lump sum. Under pension protection, the maximum lump sum is the original capital value of the pension (usually 20 times the defined benefit pension) less gross payments made and then less 55% tax.
- *Lifetime annuities* are pension payments from money purchase benefits and are bought with authorised insurance companies. These are subject to the same type of death benefit options as scheme pension payments.
- *Drawdown pensions* are available from money purchase schemes at any age from normal minimum pension age (usually 55). They allow the member to take variable withdrawals directly from the fund rather than requiring him or her to purchase an annuity. There is no minimum annual withdrawal (it can be nil) and whether there is a maximum will depend on the type of drawdown selected. If the drawdown is capped, the maximum will be 100% of a basis amount. The basis amount is derived from tables published by the Government Actuary's Department and the yield on gilts at the review date which must be at least every three years. Flexible drawdown allows unlimited payments and is available on condition that the member can demonstrate a minimum income requirement (MIR). The MIR is an income of at least £20,000 and provided by:
 - A scheme pension from a scheme that has at least 20 pensioner members.
 - A guaranteed pension annuity or the guaranteed element of an investment-linked annuity.

- An overseas pension that would fall into either of these categories if a UK pension.
- A State pension.
- Payments from the Financial Assistance Scheme.

The drawdown may be provided by means of a short-term annuity purchased by the scheme in the member's name. The annuity must be for a period not exceeding five years and offers short term stability.

In the event of death of the member, the drawdown pension may provide a survivor pension by way of drawdown, scheme pension or annuity purchase or a lump sum representing the value of the fund less tax at 55%.

Ill health early retirement

It may be possible for pension benefits to be taken before normal minimum pension age where the member is in ill health. The format in which benefits can be taken will depend on whether the member has ill health or serious ill health (i.e. has a life expectancy of less than 12 months).

Ill health benefits can be paid in the normal way, with tax-free cash and pension. If the member is in serious ill health they can receive their benefits as a lump sum, which is tax free as long as the member has sufficient lifetime allowance, any excess being subject to the 55% lifetime allowance charge.

If the serious ill-health lump sum is paid when the member has reached the age of 75, it will be subject to tax at 55%.

Triviality

Small pension benefits can be paid out as a one-off lump sum, rather than as lump sum and pension, where the following conditions have been met:

- The value of the pension rights from all registered pension schemes is not more than £18,000; and
- The member has reached age 60; and
- The individual has some unused lifetime allowance; and
- The payment discharges all the member's rights under the scheme; and
- The payment is made within 12 months of the first triviality payment (triviality payments made before 6 April 2006 do not count for this purpose).

There are separate provisions to allow payment of small lump sums, generally up to £2,000. The provisions are to 'tidy up' late paid rebates and administrative errors.

Tax planning key points

For many people, the rules became simpler in 2006. However, for those:

- Who have significant pre-2006 rights,
- Are looking for a flexible retirement income,
- Regard pensions as an important element in their tax planning,

the rules are more complicated and regularly change. They require specialist advice.

This guide is for general information only and is not intended to be advice to any specific person. You are recommended to seek competent professional advice before taking or refraining from taking action on the basis of the contents of this publication. The guide represents our understanding of the law and HM Revenue & Customs practice as at September 2011, which are subject to change.