

PRUDENTIAL SUMMARY: SIGNIFICANT PROPOSED CHANGES TO PENSION RULES

Consultation to remove compulsory annuitisation

The Coalition Government that came to power on 11 May 2010 announced that it was going to end the requirement for pension scheme members to purchase annuities by the age of 75. This was confirmed in the budget statement of 22 June 2010, and as an interim measure the Finance Bill 2010 of 1 July announced that the unsecured pension rules would be extended to age 77 as a transitional measure to defer 'compulsory annuitisation' while further consultation on rule changes takes place.

The consultation document has now been released and the government has announced that it will be engaging with employers, pension schemes, experts and other industry parties on their proposal to change the way in which consumers may draw their pensions in the future. The consultation will last eight weeks, ending on September 10th. The intention is that this will allow time to consult on draft legislation ahead of the Budget in 2011 with the new rules applying from April 2011.

What are the proposals?

- The consultation recognises that for many an annuity will always remain the best product. However the Government wishes to introduce greater flexibility to how people can take income to reflect the changing pensions and workplace environment, to encourage more pension saving and to encourage product innovation.
- The age 75 rules on annuitisation, value protection lump sums, tax free cash and trivial commutation lump sums will be removed.
- The age 75 rules on contributions and Lifetime Allowance checks will remain.
- Pension funds will be able to remain in a USP ("capped drawdown") indefinitely. ASPs will cease to exist.
- The USP maximum withdrawal limit may be reviewed. The current 120% is probably too high at older ages and may have to be less than 100% to avoid the risk of people exhausting their funds.
- There will be no minimum withdrawal requirement.
- Any withdrawals will be taxed as income.
- A USP customer will be able to access additional flexibility (in effect the permanent removal of the upper withdrawal limit) through "flexible drawdown" provided they have secured a minimum income (the Minimum Income Requirement). This minimum income will need to be a secure pension income for life and escalate by the lower of 2.5% or inflation. The customer would then be able to withdraw up to 100% of the remainder of their fund. This will be taxed as income.
- The minimum income required is not set out in the consultation paper. However it is expected to take account of not just current means-tested benefits, but also potential health costs and future expenditure needs.
- Lump sum death benefits will be taxed at 55% to counteract tax relief given - this includes value-protection payments.
- The only exception is for pension savings where no part has been used for an income when the saver dies before 75, where the pot will be tax free.

Summary

The consultation asks for responses and views on many issues in the paper including the practical working of the minimum income requirement and the appropriate income limit for capped drawdown. Though it is uncertain how much of this will be implemented, given the speed with which the coalition government has proposed change there does seem a determination to alter

the existing rules and remove many of the existing restrictions. However as the paper states annuities will continue to be the right solution for many. The possibility of reduced income for older ages is also likely to make it attractive even for those in drawdown to annuitise at some stage. It is possible that the flexible drawdown will only be an option for those with very large sums as the cost of securing income to meet the minimum income requirements is potentially onerous.

Consultation on the restriction of pensions tax relief

The government also announced in the June budget that it was considering the reform of pensions tax relief. The government has stated its reservations about the previous administrations plans regarding a 'tiered' approach to restricting tax relief for higher earners and believes that a simpler solution is a substantial reduction in the annual allowance. They have however gone to great lengths to state that any changes made by the Government 'will seek to ensure that it raises at least the same amount of revenue through restricting pensions tax relief as has already been accounted for in the public finances from the Finance Act 2010 (April)'. In short any changes must wash their face and at the very least raise the same amount of tax as expected previously. This hardly comes as a surprise.

What are the proposals?

Key to the changes is that instead of tapering, a reduced fixed annual allowance would be applied. The consultation runs until the end of August after which draft legislation will be produced in the autumn with final rules appearing in the Finance Act 2011 shortly after. The restrictions will apply from 6 April 2011.

The main points of the proposals are:

- The Annual Allowance, currently £255,000, would be reduced to around £40,000 (this figure may still change dependant on other factors). The Annual Allowance Charge for contributions which exceed this figure (currently 40% for everyone) would be changed to reflect the tax paid by the individual concerned.
- For Defined Benefit schemes the governments provisional view is that for simplicity a flat rate valuation factor should be used to determine the value of increases in defined benefit schemes. This is however likely to be higher than the current level of 10 and it is believed that the appropriate factor may be within the range of 15 - 20.
- The current Lifetime Allowance may also be reduced, with revised protection rules put in place for those already exceeding the allowance.
- Tax relief may be restricted to 40% (even for 50% tax payers).
- The exemption, which currently means that contributions made in the year of retirement are not measured against the annual allowance would be removed.
- An alignment of the pension input period to the tax year.

Summary

The reduction in the annual allowance rather than the proposed previous tiered approach will certainly simplify the advice issues for defined contribution arrangements, though there will be winners and losers. It is being considered whether concessions to the revised annual allowance may be granted in particular circumstances (for example death, ill health or redundancy) though the more concessions granted the greater the chance that the annual allowance for everyone else will reduce further.

The whole issue of how this will impact DB schemes though is a different matter entirely and the practicalities of adhering to the new rules, checking who may have exceeded the limit whilst maintaining and altering if necessary the individual scheme rules will cause concern and numerous headaches. Consideration will also need to be given to the impact on Public Sector schemes.

It is disappointing in many ways that only 5 years after the introduction of the much heralded 'pension simplification' of 2006 the government look set to introduce another set of very different

pension tax relief rules, though the reasons behind the changes are well understood. It is hoped that yet another fundamental change to the rules does not deter individuals from saving for their retirement, particularly as it is now more important than ever for individuals to take responsibility for their own welfare.

There will be many views both for and against different aspects of both of these consultations. It is unfortunate that the timing of both coincides with the holiday season, but at least the treasury is seeking external views before pressing ahead. Given the short timescale though until the introduction of both sets of rules any proposed amendments will need to be quickly assessed. Should you wish to read the full documents they can be found at the links below:

http://www.hm-treasury.gov.uk/d/consult_age_75_annuity.pdf

http://www.hm-treasury.gov.uk/d/consult_pensionsrelief_discussion.pdf