

Introduction To International Aspects Of Pensions - UK

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1. Considerations affecting retirement provision

- ◆ When do you intend to retire?
- ◆ Where are you going to retire to?
- ◆ What form and amount of income do you want to have in retirement?
- ◆ Are you confident of a regular income throughout your working life or do you anticipate that your earnings will fluctuate considerably?
- ◆ Are you going to work in the same country for the remainder of your working life or are you going to be in a number of as yet unspecified countries?

Some of these questions can be impossible to answer. For instance at the age of 30 one country may appear an idyllic potential final place in the sun. However thirty years later your expectations and views may well have changed, and the country in question may be very different. Few people can have any degree of certainty about the path that their working life will take.

2. Pension Portability

Individuals who work or live in a number of countries are faced with a more complex situation and one that is continually changing as legislation and commercial products evolve in response to each other.

Although EU legislation exists covering the transfer of state (statutory) pensions within the EU, this is typically difficult to achieve. Transfer between state pension schemes into or out of the EU or between other countries is generally not possible.

A new EU directive has been drafted recently that provides for the preservation and transfer of pension rights within countries in the EU for occupational pension schemes since these are becoming far more widely used and in some cases replace state schemes. The details of this Directive are of course subject to change during the approval process. It does not deal with tax or indexation of pension issues.

3 The Mechanics of pension provision

This section looks at the various potential sources of pension provision. These are taken to be instruments that will provide income to live on in retirement and some of these are ordinary investment methods with no specific pension association. At the end of this section there is a brief outline of the options at the time of requirement in terms of how you choose to receive that income.

4 United Kingdom

Many employees and directors will have either a company pension or a personal pension plan, and these receive privileged tax treatment in the UK - contributions into the plan carry a standard-rate tax credit, but income benefits taken later from the plan are taxable in the normal way.

Occupational schemes are the most common form of UK pension. The maximum employee contribution that can be made in any one tax year cannot exceed 15% of remuneration. For members joining from 1989 onwards, the final remuneration that can be used for calculating benefits is capped at an amount set yearly by parliament. Earnings in excess of this amount cannot be saved in a pension through a tax-approved scheme.

A self-invested personal pension scheme (SIPP) is essentially the same as any other type of personal pension, the only difference being that a person can direct the provider to make certain investments of his or her choice. Even employees working outside the UK are eligible to contribute to a personal pension scheme, provided they have relevant earnings chargeable to UK income tax. If they qualify for the 100% foreign earnings deduction (which since 17 March 1998 applies only to seafarers) they are eligible even though they do not actually pay any tax. Contributions are paid net of basic rate tax in the normal way.

Currently, all employed earners pay their contributions net of tax and get tax relief on their contributions even if they are not paying any tax. From 6 April 2005, this method of payment was extended to self-employed persons and non-tax payers, so everyone will get tax relief on their contributions even if their earnings are below the tax threshold.

For other than occupational pension schemes, the percentage limit on the amount of personal pension contributions is dependent on age at the commencement of the tax year, i.e. on the 6th April. The maximum contributions payable in each tax year are as follows:

Age 35 or less	17.5%
36-45	20%
46 - 50	25%
51 - 55	30%
56 - 60	35%
61 or more	40%

The permitted maximum, otherwise known as the earnings cap, was introduced in the Finance Act 1989, and affects both existing and future members of personal pension schemes. A limit was placed on the amount of earnings which can be pensioned through an approved personal pension scheme. This limit is reviewed annually, and for the tax year 2005-06 stands at £105,600. Earnings over this amount must be disregarded when calculating the maximum contributions which can be made in relation to a tax year.

An employer making contributions to an employee's personal pension schemes can claim tax relief through their accounts in respect of the payment. Contributions made by an employer to an approved personal pension scheme do not count as taxable pay of the employee concerned. Thus tax or National Insurance contributions do not have to be deducted from the payment.

Salary Sacrifice Schemes. The Treasury announced in December 2004 that it did not plan to shut down salary sacrifice schemes, used to reduce the amount of National Insurance contributions paid by employers on behalf of employees. Under the scheme in question, employers offer to pay for staff pension contributions in return for an equivalent cut in their salary, thus reducing the amount of NI contributions that the employer has to make. Companies using salary sacrifice schemes stand to make significant cost savings, and many had feared that the schemes would be shut down as part of reforms to the pension system due to come into effect in 2006. However, the Treasury explained

that it had no intention of tampering with the schemes, arguing that they are part of employment law rather than tax law.

Some employers also agree to collect their employees' contributions towards a personal pension scheme and pass them over to the pension provider on their behalf. The tax position is quite different for these contributions. Employees get tax relief through a special relief at source system (similar to the recently-abolished MIRAS system for mortgage relief). Tax and National Insurance are deducted from gross income in the normal way (under PAYE). The employee (or an employer acting as his agent) then pays a net contribution to the pension provider, who claims back basic rate tax from the Inland Revenue and credits it to the personal pension plan.

UK pensions will be revolutionized for all individuals and firms on A-Day - 1st April 2006. The new set of simplified pension rules replaces eight different existing sets of rules. Highlights of the new rules are:

- The amount that can be contributed to a pension in 2006-07 will rise to a maximum of £215,000. An individual may not contribute more than taxable earnings but tax relief is available on pension contributions of up to 100% of taxable earnings. An employer may make unlimited contributions to fund with full tax relief.
- The lifetime allowance (LTA), which is the maximum size pension fund that may be held without being subject to a tax surcharge. The lifetime allowance has been set at GBP1.5 million for the tax year 2006-07 and is to rise gradually to GBP1.8m by 2010-11.
- Any funds taken in excess of the lifetime allowance limit will incur a recovery charge of up to 55% if taken as cash. If the excess is taken as income, there will be a one-off 25% charge, plus tax at the marginal rate on any future income.
- Protection against these charges is available in two flavours: 'primary' or 'enhanced' protection.
- Primary protection serves to protect the fund already accrued at A Day and allows it to grow modestly in line with the annual increases in the lifetime allowance, without the fund becoming liable to a recovery charge of up to 55% on the excess. However, if a fund exceeds the relevant lifetime allowance in the year you retire, the recovery charge will have to be paid.
- Enhanced protection is available to anyone, irrespective of the size of their pension. It not only protects the current value of a fund, but allows protection any future growth in its value, due to future investment returns or pension benefit increases, without incurring a surcharge. But enhanced protection requires a halt to contributions by A-Day.
- In addition to the higher annual contribution limits (£215,000 in 2006-07), both an individual and the employer can make unlimited contributions to the fund in the year of retirement, although there will only be tax relief on contributions up to 100% of salary.
- After A-Day, it was announced that individuals can invest in just about anything, usually via a SIPP (Self Invested Personal Pension). In the November 2005 budget the Chancellor announced that residential property, including buy-to-let and holiday homes, vintage wines and "exotic assets" will be excluded. The consultation process continues until the end of 2005.
- Such investments will be taxed as a benefit in kind if there is personal use of them and there will be associated costs such as insurance and safe custody if they are kept in storage.
- Transferring pre-owned property, such as commercial property into a SIPP will involve selling the property to the pension fund at its prevailing market value. This may well create a capital gains tax liability; the pension fund will also have to pay stamp duty on the purchase and any bills associated with repair and maintenance of the property.

- Investments in 'wasting assets' (such as clocks, cars, boats and properties with leases of less than 50 years) will trigger an extra 15% tax, payable by the pension scheme.

A survey by Deloitte in November 2005 shows that hardly any companies have yet made plans for the new regime. Deloitte's partner Bill Cohen said: "Organisations are waiting to learn what their competitors are doing in respect of pension provision before they make a final decision about what changes to offer their own executives. However, time is running out and companies need to urgently agree their post A-Day policies with executives."

Cash compensation is the most popular alternative benefit and is likely to be used by 73% of respondents to the survey. UURBS and FURBS are being adopted by 27% and 10% respectively. Other options such as employee benefit trusts and family benefit trusts were much less popular.

"Companies will be sensitive to criticism from shareholders that they are continuing with generous pension policies for executives. No one wants to be seen to pay more as a result of A-Day but finding an alternative solution that meets other criteria such as retaining key talent, is not a simple decision" said Orlando Harvey Wood, partner in consulting at Deloitte.

According to new research from Clerical Medical, carried out by IQ Research, the A-day changes are likely to accelerate a trend to contract based group personal pensions schemes.

The syndicated research, conducted by IQ research, looks at the factors which have influenced this shift towards contract based group personal pensions, since the introduction of the Pensions Act in 1995. It reveals 95% of the intermediaries interviewed believe new trustee responsibilities are one of the main drivers for change in smaller occupational trust based schemes.

New changes in pensions legislation on A-Day, including the introduction of more trustee responsibilities and member nominated trustees (MNTS), are likely to speed up this shift towards contract based and stakeholder schemes, claims the research. Clerical Medical says this change in attitude will provide intermediaries with an opportunity to review their existing occupational pension scheme arrangements.

The company suggests employers and trustees of occupational schemes should discuss with their adviser whether the scheme still meets their original needs and objectives. It adds that for those who are planning to review their current arrangements, although some employers will choose to stay with their existing trustee based scheme, it may be worth while considering a switch to a contract based group personal plan or group stakeholder plan.

Funded Unapproved Retirement Benefits Scheme (FURBS). Highly-paid directors and employees who are constrained by the earnings cap can use various mechanisms to get around this difficulty. An example is a FURBS. The need for FURBS-type schemes arises because the earnings cap calculation process is detrimental for employees since historically earnings tend to rise at a faster rate than prices. This is particularly so for high earners since their pay increases are generally greater than the average. In time, wage inflation will probably outstrip price inflation, resulting in more people's pay exceeding the earnings cap.

A FURBS is a bona fide employer-sponsored retirement benefits arrangement normally established under trust, which separates the retirement funds from the resources of the sponsoring employer. Evidently, the lack of Inland Revenue approval means that contributions into the scheme come out of taxed income, on the other hand the FURBS is not subject to the restrictions on funding and investment methods applied to an approved scheme.

Unlike an approved scheme, a FURBS gives the flexibility of providing the entire benefit in the form of a lump sum (in full commutation of pension rights). An employer can establish a FURBS arrangement for a group of employees (a group scheme) or on a per member basis (individual schemes). Generally, benefits become payable on, or in connection with, retirement from or termination of service. It is possible for a FURBS to be established as either a money purchase or a defined benefit scheme or as a hybrid scheme.

It should be noted that the earnings cap can be subject to change for political reasons, and may be frozen (as was the case for the tax year 1993/94) or adjusted in future years. This uncertainty makes pension planning within the approved system difficult, and many employers may wish to consider the flexibility of a FURBS.

The rules permit a FURBS to be established in respect of : "... any pension, lump sum, gratuity or other like benefit given or to be given on retirement or on death, or in anticipation of retirement, or, in connection with past service after retirement or death, or to be given on or in anticipation of or in connection with any change in the nature of the service of the employee ..." Benefits which are payable only on the death or disability of scheme members (i.e. not available on retirement) are excluded from being relevant benefits.

An employee or director will be taxed on contributions made by his employer as a benefit-in-kind. These must be reported on the employee's annual form P11D. Since a contribution into a FURBS will give rise to a charge to tax on the employee, the income tax liability arising must be considered when determining the level of contributions. Employer contributions do not include the costs of establishment and administration.

Since 1998, an employer's contributions into a FURBS have been subject to Class 1 NIC. Most employees however will not incur an additional employee's NIC liability on an employer's FURBS contributions because they will have already reached the earnings maximum.

Provided a FURBS is maintained for the sole purpose of providing relevant benefits, its income will be taxed at the basic rate of individual income tax, instead of the normal (corporation) tax rate. As a result of the Finance Act (No.2) 1997, exempt approved schemes lost the ability to claim (re)payment of tax credits on dividends received. Thus, the effective tax treatment of dividends received into both approved and unapproved schemes is now identical.

FURBS can be established as offshore trusts; normally a 'roll-up' structure would be employed so as to avoid adverse tax treatment of the trust's income under general anti-avoidance legislation or under capital gains tax legislation.

In 2004 the UK government decided to increase taxes on individual pensions. New rules due to be introduced from April 2006 will affect how pension pots exceeding £1.5 million are to be taxed. Some experts have suggested those who have earned more than £150,000 for a long duration will be hit hardest. Cliff Weight, a director of Independent Remuneration Solutions, spoke in September, 2004, of growing evidence that the salaries of the UK's top executives are increasing as they seek to avoid being hit by the new tax provisions, which could subject their pensions to tax at up to 55%.

"I predict a surge in salaries as directors seek to maximise their pension benefit prior to the new pension rules becoming effective," stated Mr Weight. However, the value of a pension pot before April 2006 may be 'protected' from the new regime through effective tax planning, noted Mr Weight, who believes increasing salary levels resulting in higher transfer values on final salary schemes are motivated by the new tax rules. "The enhanced protection provision makes it attractive to accelerate future salary increases before April 2006," he observed.

A report released in February by consulting firm Deloitte supported this reading of the situation, calculating that almost half of FTSE100 directors will face the 55% tax on their retirement savings. According to Deloitte, 41% of directors at firms listed in the FTSE 100 will find themselves over the £1.5 million pension tax relief threshold.

Deloitte also predicted that the changes would affect 23% of the directors serving with FTSE 250-listed firms, with the directors affected being those who joined their companies' final salary schemes before 1989, leaving them without an annual cap on contributions.

The European Commission announced in 2004 that it would take action against the United Kingdom over the application of tax laws relating to pension contributions. The EC pointed out that in the UK, exemption from income tax of employer contributions and deductibility of

employee paid contributions depends on the form of the pension arrangement (a trust) and the presence of a representative in the respective Member State to fulfil the administrative duties.

It therefore formally requested that the United Kingdom bring about changes to these rules by extending the favourable tax treatment to contributions paid to schemes not fulfilling these specific national requirements.

In January 2005, meanwhile, the government announced new rules designed to allow investors to buy property as part of their retirement savings. Then in November 2005, they excluded residential property. Under the new rules, which come into force in April 2006, individuals will be able to purchase commercial property, as part of a personal pension, enabling them to gain a major tax advantage. Although rental income from a commercial property will need to be reinvested in the fund and used to pay off a mortgage, it will be exempt from income tax, and gains from the sale of the property will also be free from capital gains tax.

Furthermore, contributions made to a pension plan in order to buy property will receive tax relief at 22 pence for every 78 pence invested, and higher rate taxpayers will receive an additional 18 pence.