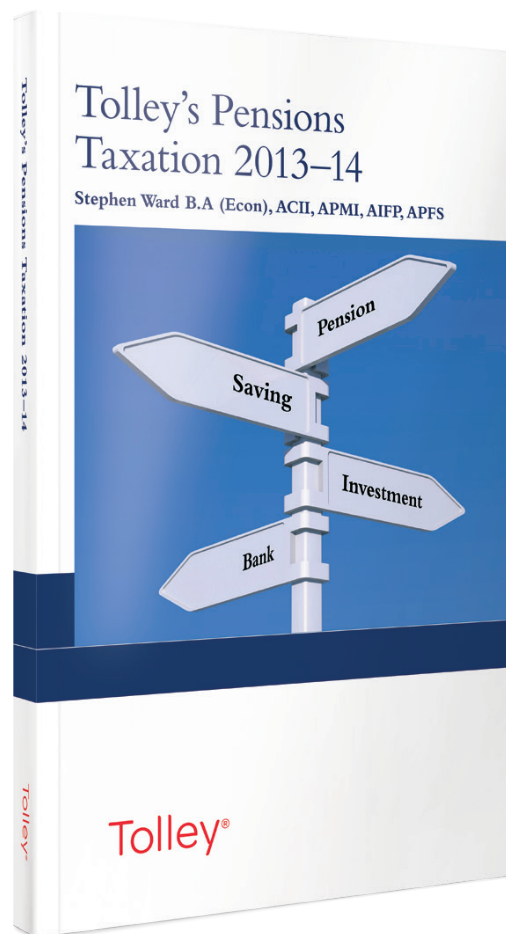
TOLLEY'S PENSIONS TAXATION 2013-2014

Chapter 1
- Introduction and the 'legacy'



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1 Introduction and the ’legacy’

[1.1]

For many years the United Kingdom has operated a system which encourages private pension provision through a system of tax reliefs. In this book we set out how the pensions taxation system works and how that system fits into the UK system of taxation generally.

The operation of the taxation system associated with pensions was radically reformed in the Finance Act 2004 which effectively disposed of a complex system that had developed since the last occasion of radical reform in 1970. This new basis was introduced with effect from 6 April 2006.

Sadly over the years between the implementation of the Finance Act 2004 reforms and the current time many of the principles associated with those reforms have disappeared. We risk once again ending up with a pensions taxation system that very few people will be able to understand. In fact we are probably there already. This is the third edition of this publication and its insane that the ongoing ‘meddling’ necessitates further revisions as the legislation continues to change. Even now we still hear the inane claim of ‘amending the legislation to bring it in line with the original policy intent’.

The purpose of this book is not to cover every tiniest piece of minutiae associated with the tax regime for pensions which is introduced in this chapter and set out from Chapter 2 onwards. What we hope to achieve is comprehensive coverage of the ‘mainstream’ associated with the new regime which will deal with nearly all situations that practitioners will encounter from day-to-day.

Wherever applicable reference will be made to the relevant legislation, which in the main is surprisingly accessible and understandable although in certain complex areas this is something which you will not always agree with.

However firstly and in this chapter we will look at how it is we ended up with where we were before the reforms came into effect.

Pensions taxation from 1921 to 1970 – occupational pension schemes AND THEIR DEVELOPMENT FROM VICTORIAN TIMES

[1.2]

In nineteenth century Britain the older generation were less visible as the percentage of the population represented by those over age 65 never exceeded 5% of the Victorian population as a whole. Life expectancy did not exceed 65 until well into the twentieth century. Those who reached age 65 were hardly likely to be able to afford to retire in the main. Continuing to work into old age was the norm until prevented by incapacity. Lighter work was often offered albeit at lower wages.

In 1901 life expectancy was 45 years for men and 49 years for women. Scientific advance and improvements in sanitation, hygiene, living conditions and nutrition of the population all contributed to a fall in deaths of infectious disease by the mid- to late twentieth century. For example, tuberculosis killed about 80,000 people in 1880. In 1997 the disease killed only 440.

The First World War, the influenza outbreak soon after, the economic depression in the late 1920s and the Second World War all had an unfavourable impact on the life-expectation of new born children. In 1918 boys could expect to live until they were 44 and girls until they were 50. In 1914 the respective figures were 52 and 55 years. To put this into perspective by 2012 this had increased to 79 years for men and 83 years for women. Life expectancy is expected to rise further by 2032 to 83 years for men and to 87 years for women. This projection is based on current trends. The precise extent of the increase will depend on patterns of disease and population lifestyle.

The foundations of an occupational pensions system are to be found in the development of the Civil Service pension scheme. For those employed in Government service various pension systems were well developed by the early nineteenth century. An office of employment was sometimes purchased from the previous job holder in return for a lump sum or periodic payments to the previous incumbent. But the Civil Service pension scheme was to become an important model in particular as it offered generous benefit levels and from as early as 1859 in a form that practitioners will recognise today. From that date the scheme offered on a non-contributory basis a pension from age 60 or later of one sixtieth of final pay for each year of service with a maximum of forty years to count. This generous level of provision became the objective for other public sector employees and as will be familiar eventually spilled over into the private sector forming the origins of the framework of a maximum permitted level of benefits from an occupational pension scheme that survived until 2006.

In Victorian times private sector employer pension schemes tended to operate on an ‘ex gratia’ basis. But as the nineteenth century progressed there was an acceptance by some employers (in particular the Railways) and some financial institutions that it was more appropriate to put in place schemes offering set levels of benefit. These were generally achieved by a form of ‘book reserve’ system where funding was set aside on the employer's balance sheet. However the schemes established by the Railways were generally based upon funds that were set aside, separate from the employer and protected in the event of the employer's bankruptcy. Some schemes allowed for a part of the member's pension to be exchanged for a lump sum.

By the late nineteenth century most of the railway companies had put in place a pension scheme of one form or another for their management and clerical staff. A typical scheme would require the member to pay in perhaps 2.5% of his pay with a matching contribution from the employer. The fund would then be invested either on deposit with the employer or into fixed interest securities with the employer guaranteeing a rate of interest on the fund. The emerging pension was based on service, typically around 25% of average pay after ten years, and two-thirds after 45 years. Compulsory membership was usual.

In this early period there also existed ‘money purchase schemes’, where the eventual pension available depended on the contributions made by employer and employee plus interest earned.

In this period schemes were also being introduced by banks and insurance companies. However from the limited data available the membership of formal pension schemes in the private and public sector was in the region of just 5% of the workforce at that time.

One of the first known trust-based schemes was set up by Colemans (the Norwich-based mustard manufacturer) in 1900. It became accepted that the use of a pension trust was a low cost and effective vehicle for establishing a pension scheme. Not all adopted this vehicle but tax reforms in

1921 resulted in their becoming the de facto method of governance.

Until then most pension funds paid income tax on at least a part of their investment income but there was no consistency of treatment between different tax offices around the country. Lobbying Government for uniformity began in 1917 through an 11 strong Conference of Superannuation Funds. By 1919 membership had grown to 55 Superannuation Funds representing employers across industry and commerce. The pressure exerted led to the 'grandfather' of modern day pensions legislation, the 1921 Finance Act.

A quick look at the 1921 Finance Act reveals statements in the legislation that even now will seem remarkably familiar. Section 21 of the 1921 Finance Act introduces the:

> '"exemption of superannuation funds from income tax in respect of income derived from investments or deposits of the superannuation funds."'

In addition the Act provided that:

> '"any sum paid by the employer or employed person by way of contribution towards the superannuation fund shall … be deducted as an expense incurred in the year in which the sum is paid."'

The 1921 Finance Act introduced the concept of '*ordinary annual contributions*' and a spreading of tax relief where any contribution was not regarded as an ordinary annual contribution.

To be a superannuation fund it was necessary that the scheme be:

> '"established under irrevocable trusts in connection with some trade or undertaking carried on in the United Kingdom".'

and that

> '"the fund has for its sole purpose the provision of annuities for persons employed in the trade or undertaking either on retirement at a specified age or on becoming incapacitated at some earlier age."'

A superannuation fund (clearly the old form of words for an occupational pension scheme) was subject to approval by the Inland Revenue Commissioners.

The wordings contained in the 1921 Finance Act are repeated more or less word for word in the 1952 Income Tax Act in section 379 onwards, and again in the 1970 Income and Corporation Taxes Act in section 208 onwards.

The members of the Conference of Superannuation Funds were encouraged by the success of their lobbying and became constituted in the form of the Association of Superannuation and Pension funds in 1923. Although self-administered pension trusts flourished an increasing number of employers took advantage of the burgeoning interest of life insurance companies in the pensions industry. Indeed for small- to medium-sized employers the specialist record keeping and investment services of a life office were felt essential. By 1934 five major UK life offices involved in the group pensions market had schemes under their management covering around 120,000 and 20,000 members, this growing to over 2.25 million members by 1956.

The tax efficiency of pension savings was becoming ever more apparent. The standard rate of income tax (what we would now referred to as the basic rate) was as high as 50% during the Second World War with company taxation on the margin being as high as 100%. Those employed in the insurance industry selling group pension contracts were readily able to sell their wares to employers, in particular those who are paying '100% excess profits tax', as relief on contributions to a pension scheme essentially reduced the net cost to zero.

So-called 'top hat' schemes which offered generous pension benefits for senior employees either on a standalone basis or as a supplementary arrangement over and above the pension scheme generally operated also became popular. Frequently these were funded by employer contributions available as a consequence of a salary reduction or foregoing a salary increase (what we would today refer to as salary sacrifice). The contributions, which would be fully tax allowable on the employer, then being used to perhaps to purchase an endowment policy designed to provide a tax-free lump sum on retirement.

The tax incentives were undoubtedly effective as by 1956, according to the Government Actuary, the proportion of workers in occupational schemes was 33%, most of the growth in participation having occurred since the end of the war. By 1956–57 the annual cost to the Exchequer of pensions tax relief had reached £120 million.

Over the years as the cost of pensions tax relief increased there were the beginnings of restrictions. One of these will sound familiar as it was maintained until 2006. During the 1940s the Inland Revenue began to restrict the tax relief available on employee contributions to 15% of remuneration. In the late 1940s there came pressure for legislation to curb what was seen as abuses of the tax reliefs available in particular in relation to 'top hat' schemes for higher paid employees. Lump sums secured from such arrangements were regarded as capital when paid out and escaped tax altogether. The 1947 Finance Act introduced a provision limiting the lump sum to 25% of the total value of pension rights. Again this will sound familiar resonating with the pensions tax legislation of today.

However the 1947 Finance Act has been described as 'no more than a makeshift patchwork, covering a fundamentally rotten edifice of conflicting tax privileges for different types of pension schemes'. The system as it had by then developed was full of anomalies with different rules operational between insured pension schemes (excepting those written as trusts), and schemes subject to the 1921 Finance Act provisions.

In 1948 a committee was formed with representatives of four different trade bodies proposing pensions tax simplification. The proposals were that all reasonable contributions to pension schemes should be tax deductible and benefits on receipt should be subject to taxation. It took until 1950 however for Government to appoint a committee which took a further four years to report in the form of the 1956 Millard Tucker report. Sadly the industry-based wish for simplification was ignored with proposals limited to a little standardisation across the different types of scheme then available.

The committee proposals were only partially implemented in 1954 but with a concession to the self-employed with the introduction of retirement annuity policies. However even that concession was very limited with contributions at the time restricted to just 10% of earnings or £750 a year if less and with no tax-free lump sum provision.

An unintended consequence arose from the 1947 Act introduction of a lump sum representing up to 25% of the value of total benefits. This led to hybrid schemes developing which benefited from the tax privileges introduced in the 1921 Act, whilst another section of the scheme allowed for a lump sum up to the maximum permitted. This was highly effective even though the fund build-up of the element

associated with the lump sum was not free from tax.

By 1967 occupational pension participation had reached 53 per cent of the workforce. By the 1960s, therefore, occupational pensions had moved from a 'niche' position to a central role in Britain's system of pension provision.

As stated previously the last occasion of major pensions taxation reform prior to Finance Act 2004 was in 1970. The 1970 Income and Corporation Taxes Act consolidated previous legislation with its provisions associated with pensions being phased out over the following 10 years. The earlier (pre 1970) provisions (consolidated in the 1952 Income and Corporation Taxes Act) became known as the 'old code'.

The 'new code' was introduced by the Finance Act 1970, and occupational pension schemes in force in 1970 were given 10 years to bring their rules into line with the 'new' legislation. This process of 'phasing in' is in stark contrast to what happened on 6 April 2006 when the Finance Act 2004 reforms were implemented and the entire pensions taxation landscape changed overnight.

The 1970 reforms weren't really about reducing complexity but more about producing a more modern system. In fact if you were to look at the legislation associated with pensions taxation as it existed before 1970 not a great deal had changed since 1921 so far as it related to the taxation rules associated with occupational pension schemes.

For the first time the 1970 Finance Act provisions were retrospective in that all new schemes had to conform by 1973 and all old schemes had to comply by 1980. These changes delivered a relatively uniform set of tax rules that operated across different types of pension schemes. The overall regime was the most generous seen to date. This generosity of tax privileges encouraged a huge growth in pension schemes which eventually accounted for around a third of the entire personal sector savings in the UK economy.

The introduction of pensions for the self-employed and those not eligible to join occupational pension schemes

[1.3]

Section 226 of the 1970 Income and Corporation Taxes Act reminds us of the introduction of retirement annuity policies – originally introduced in the 1956 Finance Act which had implemented the main recommendations of the 1954 Millard Tucker No. 2 Committee on the introduction of tax efficient pension arrangements for the self-employed.

Retirement annuities were tax relieved pension arrangements available only from insurance companies (and thus often referred to as retirement annuity contracts or RAC's) available to the self-employed and those who were not eligible to join superannuation schemes. These arrangements allowed the retirement annuity policy holder to pay tax relieved pension contributions of (at that time) up to 15% of 'net relevant earnings'.

Those eligible for retirement annuities included shareholding directors of director-controlled companies who indirectly or directly owned or controlled 5% or more of the shares. This was important as company directors falling into this category were not allowed to participate in an occupational pension schemes – not until 1973 anyway.

Retirement annuities and their successor, personal pensions, are considered later in this chapter.

1970 – The operation of two tax regimes

[1.4]

By 1970 therefore, we had a set of rules associated with superannuation schemes (which we will from now on refer to as occupational pension schemes), and a further set of rules associated with retirement annuities.

But even in the period up to 1970 it was necessary to use some fairly complex structures to maximise the tax benefits associated with pension arrangements because of the interaction between the legislation associated with pension benefits and that associated with tax-free lump sums.

So occupational schemes established under the 1952 legislation (which provided for pensions and tax-free lump sums) were approved under section 379 (pensions) and section 388 (lump sum), the provisions of which were repeated in the 1970 Income and Corporation Taxes Act under sections 208 (pensions) and 222 (lump sum). More background to the evolution of the concept of the 'tax-free lump sum', and how the legislation dealt with it is set out later in this chapter.

Thus the 1970 Finance Act introduced the 'new code of approval'. The provisions contained in the 1970 Income and Corporation Taxes Act became known as the 'old code of approval'. Schemes generally had to conform to the new code provisions by 1980.

Occupational pensions – from 1980

[1.5]

From 1980 onwards the 'new code' was all that existed so far as occupational schemes were concerned, and so the coexistence of these provisions with the retirement annuity legislation meant that now there were two pensions taxation regimes.

The occupational pension regime established in 1970 was based upon the ability of employers to provide a pension which was not allowed to exceed two thirds of final pay. The occupational scheme design principle and the accompanying tax approval based upon the principle of '60ths of final pay' astonishingly goes back to 1859 when earlier Civil Service pension schemes were replaced with a single one which provided for a pension of 1/60 of final pay for each year of service with a maximum 40 years to count and a pension age of 60.

Although under the 'new code' the maximum two thirds of final pay pension could normally accrue over a period of 40 years (based upon the principle of accruing a benefit of 1/60 of final pay for each year of service with the employer – generally referred to as N/60 where 'N' referred to the number of years of continuous service), a process of what was referred to as 'accelerated accrual' allowed the

maximum permitted pension benefit to be achieved over just 10 years of employment.

Part of the pension earned in this way could be commuted (that is exchanged) for a tax-free lump sum of up to 1.5 times final earnings. The normal accrual of the lump sum was at the rate of 3/80 of final pay in respect of each year of scheme membership (3N/80 where 'N' referred to the number of years of continuous service) but an 'accelerated accrual' basis relating to the lump sum allowed the maximum amount to be accumulated over just twenty years.

The occupational pension fund itself was exempt from taxation on its income and capital gains, and schemes were generally subject to the discretionary approval of the Inland Revenue. Schemes that provided for pension provision based on no more than the 'N/60' principle (with associated dependents benefits again not exceeding certain limits, and lump sum death benefits not exceeding twice salary at the date of death) were subject to 'mandatory approval' as the Inland Revenue were bound to approve such a scheme.

Where benefits provided were greater than those associated with 'mandatory approval' then approval of the scheme was at the discretion of the Inland Revenue. Approval was granted by the superannuation funds office (SFO) which was later renamed the pension schemes office (PSO).

In order to give practitioners, employers and scheme members alike guidance as to how the Inland Revenue would exercise their discretionary powers there was published the so-called 'practice notes' under reference IR12. These practice notes were updated periodically and supplemented by updates issue periodically by the SFO and later the PSO.

Schemes approved under the 1970 Finance Act became known as 'exempt approved schemes'. The term 'exempt' arising not because of exemption of the fund from taxation, but because of an exemption from tax as a benefit in kind on employer contributions to such schemes in the hands of the member.

The essence of the UK pensions regime is one where contributions are tax relieved and where employer contributions are not taxable in the hands of the member as a benefit in kind, where the fund is allowed to grow (more or less) free from taxation, and where the benefits (with the exception of that 'much loved anomaly' the tax-free lump sum) are taxed. This is known as an 'EET' taxation system (see Chapter 2) – and has operated in that way really since 1921 as outlined above.

Pension planning for 'controlling directors'

[1.6]

With effect from April 1973 controlling directors were allowed to join occupational pension schemes. Restrictions were later introduced in terms of how benefits had to be calculated for directors who controlled directly or indirectly 20% or more of the share capital of a director controlled company.

There were further developments as time progressed. These were introduced often as a response to perceived 'abuse', in particular following the ability of controlling directors to become members of occupational pension schemes. As controlling directors by definition had a large measure of control over their remuneration they were able to manipulate their pattern of remuneration for the purposes of the maximum benefit rules – in particular those associated with tax-free lump sums.

Controlling directors were defined as directors of director controlled companies where the director

> '"either on his own or with one or more associates, [was] the beneficial owner of, or able, directly or through the medium of other companies or by any other indirect means, to control 20 per cent. or over of the ordinary share capital of the company."'

In relation to the maximum benefit rules, the definition of final remuneration for controlling directors became

> '"the average of any three or more years consecutive earnings ending not more than ten years before the date of which benefits were taken".'

The opening up of occupational scheme membership for controlling directors from 1973 lead directly to the introduction of self administered schemes for one or more controlling directors. These schemes allowed for 'self investment' back into the sponsoring employer and other obvious conflicts of interest between the scheme member as an individual and his capacity as a controlling director of the sponsoring employer. Additional controls were therefore introduced from 1976 that were particularly aimed at what became known as 'small self-administered schemes' (SSAS or SSAPS), containing up to 11 members. These are described in Chapter 6.

The evolution of the 'tax-free lump sum'

[1.7]

Leslie Hannah (Inventing Retirement: The Development of Occupational Pensions in Britain – 1986) described the evolution of the tax-free lump sum of 25 per cent of the pension fund in the following words:

> ''The chapter of accidents which led in absurd progression to this situation, [the tax-free lump sum] which was initially desired by no one, began in the early years of [the 20th] century' (Hannah, 1986: page 115).'

Hannah notes that at the turn of the 20th century, occupational pension schemes varied widely as to whether they paid benefit as a pension, as a lump sum, or as an annuity. There were arguments that suggested a lump sum would ease the progression from working to retirement, but against this was the concern that a lump sum would be frittered away.

The Radley Commission on the Civil Service said in 1888:

> '"The payment … of a lump sum is open to the obvious objection that in the event of improvidence or misfortune in the use of it, the retired public servant may be reduced to circumstances which might lead to his being an applicant for public or private charity".'

tax exempt funds. So a structure evolved of split schemes, a tax-exempt scheme which provided for the pension benefit, and a non-tax-exempt scheme which provided for the lump sum. But as to the tax status of the lump sum (as in fact with much more of the evolution of occupational pension limits than we have alluded to above), we have to turn to what happened with the Civil Service pension scheme which as stated above began its modern day life in 1859.

The Civil Service in 1909 had negotiated a tax-free lump sum, to ensure comparability with widows' pension rights in the railways pension schemes, and in the course of those negotiations the tax-free lump sum was extended as a provision available to those who survived to retirement age. The Inland Revenue, whose work-force would of course benefit, were asked to agree to this scheme, which they (perhaps not surprisingly) did. And so the basis on which the 'tax-free lump sum' was as a consequence of this deal.

The 1947 Finance Act attempted to clamp down on the proliferation of occupational pension schemes that had attempted to get round the 1921 Act, (by providing a lump sum from non tax exempt funds) and abolished all tax-free lump sums except those that were 'reasonable'. The definition of 'reasonable' adopted by those who drafted this legislation was the same level of benefits that they themselves enjoyed.

The 1956 Finance Act, which introduced retirement annuities, explicitly did not allow for tax-free lump sums, but pressure from private sector schemes to mimic the 'reasonableness' of the Civil Service scheme meant that from 1970 all pension schemes were explicitly permitted to pay tax-free lump sums from untaxed funds. By 1971 one third of private sector schemes paid a lump sum as part of the pension scheme entitlement. This proportion had risen to more than 90 per cent by 1979.

Attempts to remove the tax – free treatment of the lump sum in the 1980s were derailed by what the then Chancellor of the Exchequer (Nigel Lawson) later described as *'the most astonishing lobbying campaign of my political career'* and, in the face of such strong political opposition, UK pension policy has since had to concentrate on limiting the anomaly of the tax free lump sum to 25 per cent rather than the more obvious policy of abolishing it altogether.

The run up to April 2006

[1.8]

Throughout this earlier period and up to April 2006 the relationship between scheme operators, their advisers, and the Inland Revenue was generally one where the Inland Revenue were regarded as being helpful unless it was blatantly obvious that the rules were being wilfully abused. The ultimate sanction whereby the Inland Revenue could withdraw pension scheme approval with the associated and dire taxation consequences was only ever used in the most extreme of cases.

If the trustees of a particular scheme had misbehaved in some way it was usually possible to come to an agreed arrangement with the Inland Revenue with or without a trip to their offices in Nottingham. It was the discretionary basis of scheme approval by the Inland Revenue that made it possible to 'do a deal', and so the withdrawal of the approval of a pension scheme was almost unheard of.

How the UK ended up with eight pensions taxation regimes

[1.9]

So far as occupational schemes were concerned the arrangements set out above continued with an ongoing process of evolution right up until 6 April 2006. The problem was that by that time we no longer had two taxation regimes associated with UK pensions – there were eight.

The purpose of the consultation process that led up to the implementation of the Finance Act 2004 was originally one of 'pensions simplification'. All the same one rarely uses that term these days in polite company.

However before outlining the pensions taxation reforms introduced from April 2006 we should consider how on earth it was that we ended up with eight taxation regimes associated with pensions by the year 2000, when in the mid-1980s there were only two. Much is owed in this regard to attempts to limit the tax-free lump sum.

As we have seen private sector pension schemes generally gave a pension at retirement with the option to commute it for a lump sum within certain limits. The benefits of most pension scheme members were related to a fraction of final remuneration dependent on their length of service with associated benefits for a surviving spouse or other dependent following death either before or after retirement.

Schemes which adopt this basis are known as final salary or defined benefit schemes. The most common accrual rate found in scheme rules is 1/60 of final remuneration for each year of service up to a maximum of 40. This scale of benefit is sometimes referred to as 'straight 60ths' or 'N/60' where N is the number of years' pensionable service with the employer providing the benefit. And as we have seen it was possible through 'accelerated accrual' to be provided with the maximum permitted pension of two thirds of final pay after just 10 years service.

By the mid-1980s money purchase or defined contribution schemes were already becoming an increasingly popular option so that employers could avoid the long-term obligations and liabilities associated with operating a final salary scheme. Exactly the same limits, with regard to the maximum permitted benefits associated with pension provision to be consistent with discretionary approval by the Inland Revenue, applied to defined contribution schemes in the same way as they applied to final salary schemes.

And as stated above small self-administered schemes for company directors had started developing in the 1970s with additional controls from 1976. Given that company pension contributions were allowed as a business expense for taxation purposes it should come as no great surprise that schemes were often set up for the directors of director controlled businesses which because of the generous earnings related benefits that could be provided at retirement were able to receive large contributions. Contributions of in excess of 10 times a directors pay (bearing in mind that this was also subject to personal control in effect) were far from uncommon.

As it was possible to fund for the maximum permitted tax-free lump sum of up to 1.5 times final remuneration as a benefit that could be provided without any pension at all and after just twenty years continuous service the scope for what was seen as manipulation of the tax rules in order to

avoid high levels of personal and corporate taxation was something that was seen to merit action by government.

Thus Finance (No 2) Act 1987 introduced the first major tax reforms for pensions since 1970 – and introduced the third and fourth tax regimes.

The major changes were:

(1) New style personal pensions from 1988 to eventually replace retirement annuity contracts;

(2) Arrangements for members of occupational pension schemes to have the right to pay free-standing additional voluntary contributions to a separate pension plan of their choice (a FSAVCS);

(3) The scope for manipulating pensions tax relief particularly by very high earners, was curbed.

The latter was achieved by:

- Tightening up the definition of final pay to prevent unacceptable inflation of the figure on which benefits were based due to indexation in line with the retail prices index,
- Placing a limit of £150,000 on the tax free lump sum available from retirement annuity policies,
- Requiring the maximum permitted pension from an occupational pension scheme to accrue over a longer period than previously (20 years instead of 10).
- An additional restriction so that the accelerated accrual of the permitted lump sum benefit was possible only to the same extent that pension benefits were uplifted. This was a major change in that it now meant the maximum permitted lump sum of 1.5 times final pay could only be achieved if firstly the maximum permitted pension of ⅔ of final pay was able to be provided.
- These changes however only applied in respect of new pension schemes set up from 17 March 1987 (this was the date of the 1987 Budget), and to new members of existing pension schemes with effect from the same date. Some practitioners remembered this date as it happened to be St Patrick's Day.

So Finance (No2) Act 1987 introduced a further two tax regimes for pensions – that associated with what was then referred to the 'post 1987' basis for occupational pension schemes, and that associated with personal pensions (see below), which were introduced from July 1988.

Unfortunately the mechanism that was adopted in order to restrict the tax free lump sum as set out above in relation to occupational pension schemes was over complex and almost impossible to express in a way that any pension scheme member would be able to understand.

This was corrected in the 1989 Finance Act. But at the same time the opportunity was taken to introduce further measures that would further constrain permitted pension benefits, and so as a consequence restricted the ability of individuals and their employers to obtain tax relief on pension contributions.

The key provisions of the 1989 Finance Act were:

- The statutory requirement for the approval of occupational pension schemes that any other schemes of the employer must also be approved was repealed. This allowed the introduction of non-approved 'top up' schemes which quickly became known as 'funded unapproved retirement benefit schemes' (FURBS), and 'unfunded unapproved retirement benefit schemes' (UURBS).
- The introduction of a statutory limit on the maximum earnings (starting at £60,000 but indexed in line with prices) that could count for pension purposes through an approved scheme (this became known as the 'earnings cap').
- The introduction of a revised and simplified maximum basis for the limit on on the accelerated accrual of lump sum retirement benefits. This amounted to 2.25 times the initial pension payable. This calculation basis arose from the fact that the maximum permitted pension was ⅔ of final pay and of course 2.25 times this figure equals 1.5 times final pay.

The revised limits (and the earnings cap) only applied to new schemes set up after 13 March 1989 (budget day of that year) and to new members of existing schemes who joined after 31 May 1989.

So if a pension scheme was set up before 14 March, 1989 and the member joined the scheme between 17 March 1987 and 31 May, 1989, the member was then said to belong to the '1987-1989 regime'.

The earnings cap was, until its abolition in 2006, increased in line with the index of retail prices, with the resultant figure rounded up to the next £600 with the relevant figures as shown in Table 1.

Table 1 The Earnings cap 1989–2006

1989–90	£60,000	1998–99	£87,600
1990–91	£64,800	1999–2000	£90,600
1991–92	£71,400	2000–01	£91,800
1992–93	£75,000	2001–02	£95,400
1993–94	£75,000	2002–03	£97,200
1994–95	£76,800	2004–05	£99,000
1995–96	£78,600	2005–06	£102,000
1996–97	£82,200	2005–06	£105,600
1997–98	£84,000		

The Finance Act 1989 therefore had the effect of adding a further four pensions tax regimes which by

now meant that the regimes comprised:

(1) Retirement annuities (no new RACs were possible after 30 June 1988, although contributions into existing arrangements were allowed to continue).

(2) Personal pensions – introduced 1 July 1988 (originally intended to be from 6 April 1988 but the legislation simply was not ready in time).

(3) Occupational pensions subject to the 'pre-1987' provisions.

(4) Occupational pensions subject to the provisions that were in place between 1987 and 1989.

(5) Occupational pension subject to the 'post-1989' provisions.

(6) FURBS.

(7) UURBS.

(8) Regimes within the old code rules that could still apply to people who joined a scheme before 1970.

Retirement annuities and personal pensions

[1.10]

To complete this historical review it is necessary to also make a mention of retirement annuities and their successor, personal pensions. Retirement annuity policies (RAPs) were the predecessors of personal pension plans. RAPs were subject to contribution limits set as an age-related percentage of earnings (the earnings that counted for this purpose were known as 'net relevant earnings', which broadly equated to earned income). From time to time the contribution limits associated with retirement annuity policies increased.

The Millard Tucker report of the 1950s made recommendations regarding the retirement arrangements for the self-employed. It was recommended that the self-employed should enjoy adequate relief under the taxation system so as to enable them to make proper provision for their old age. This led to the introduction of retirement annuity policies (RAP's) in 1956 through sections 22 and 23 of the Finance Act 1956. The original legislation set a contribution limit for tax relief purposes at £750 or 10% of net relevant earnings (with higher limits for those born before 1916). The legislation was re-enacted in 1970 (section 226 of the Income and Corporation Taxes Act 1970).

Section 20 of and Schedule 2 to Finance Act 1971 introduced cash commutation, the option to take part of the pension as a tax free cash lump sum, and increased the maximum amount of tax relievable contributions from £750 or 10% of net relevant earnings, to £1,500 or 15% of net relevant earnings.

This legislation also enabled provision to be made, within the total allowable contributions, for a widow's pension or lump sum to be paid in the event of the policyholder's death before age 75 (originally age 70). This led to the development of so-called Section 226A insurance policies as Finance Act 1971 introduced Section 226A into the 1970 legislation. The limit of premiums payable for these policies was 5% of net relevant earnings.

The 15% of net relevant earnings limit remained in force with the overall maximum contributions increased to £2,250 in the Finance Act 1976, and to £3,000 in the Finance Act 1977. In the Finance Act 1980 the overriding monetary limit of £3,000 was abolished and the maximum contribution level was increased to 17.5% of net relevant earnings. Throughout there were higher limits for those at older ages.

'Net relevant earnings' (originally defined in section 227 of ICTA 1970) were an individual's relevant earnings (which left out of account any earned income which carried pension rights) less certain deductions. Finance Act 1980 amended the definition of net relevant earnings and it was then no longer necessary to deduct personal mortgage interest from relevant earnings when calculating net relevant earnings

No new RAPs could be started after 30 June 1988, as personal pensions were introduced from the following day. Most existing RAPs continued to accept additional premiums, and many continue to exist to this day.

The accumulated fund from these arrangements had to be used to provide an annuity from a life office sometime between age 60 and 75. Part of the fund could be used to provide a tax-free lump sum. The extent of the permitted lump sum was based upon a formula whereby the lump sum could be up to three times the pension that remained after the lump sum had been taken. Because of the inclusion of guaranteed annuity rates in retirement annuity policies, in particular those issued up to the early 1980s, right up to the implementation of the Finance Act 2004 provisions some retirement annuity policies were able to pay out lump sums of well over 30% of the policy value.

As we have seen over the period from 1970 the permitted contributions to RAPs (expressed as a percentage of net relevant earnings in various age bands), increased from time to time.

There were additional provisions known as 'carry back' and 'carry forward'. Carry back enabled an individual to elect that the contributions paid in any tax year were treated for the purposes of tax relief as having been paid in the previous tax year. Carry forward enabled unused tax relief that had been available in up to six previous tax years to be used up. By combining 'carry back' and 'carry forward' it was possible to take advantage of income tax relief that had been available over up to seven previous tax years.

The new personal pension regime introduced from 1 July 1988 built on the RAP provisions and introduced a degree of much needed simplification. Legislation governing the approval and tax treatment of personal pension schemes is to be found in the Income and Corporation Taxes Act 1988 (ICTA 1988), Chapter IV, Part XIV and was repealed by Finance Act 2004.

Personal pensions like their RAP predecessor allowed the pension fund to accumulate free from capital gains tax and free from income tax on most forms of income received by the fund. However the range of providers able to operate personal pension schemes was (and is) much wider than that associated with retirement annuity policies. The latter were only able to be provided by life insurance companies, whereas personal pension schemes could be operated by life offices, banks, building societies and unit trust companies and the like.

A key benefit retained by those who had retirement annuity policies was that these policies remained unaffected by the later introduction of the earnings cap in Finance Act 1989. But RAPs were subject to

the £150,000 limit for lump sum benefits introduced in 1987. This limit did not apply to personal pensions. And the earnings cap did not apply to RAP contributions – it did however apply to personal pensions.

There also remained a complex interaction of how the carry forward and carry back rules worked for those who had both retirement annuity policies and personal pension arrangements. Personal pensions (PPs) were therefore also designed, like their predecessor, as a pension savings vehicle for the self-employed and employees who were not members of occupational pension schemes.

A variant on the personal pension, (Stakeholder personal pensions) became available from 6 April 2001. The 1998 Pensions Green Paper, 'A new contract for welfare: Partnership in Pensions', set in train the development of stakeholder personal pensions. What started life as a pension arrangement for the low paid with a maximum contribution of £3,600 per year became a personal pension variant for medium and high earners. Stakeholder personal pensions shared the same tax regime as non-stakeholder personal pensions.

Stakeholder personal pensions were the consequence of a Government initiative to reduce the management costs associated with private pension provision. Stakeholder schemes were subject to a cap on the permitted charges but in every other respect behaved like personal pensions generally.

However the stakeholder version of personal pensions is subject to an additional layer of Department of Work and Pensions (DWP) Regulations (The Stakeholder Pension Schemes Regulations 2000, SI 200/1403, as amended), covering such areas as charges and employer access. The introduction of 'auto enrolment' into workplace pensions (see Chapter 14), removes the necessity for employers with five or more employees to designate and offer access to a Stakeholder personal pension scheme.

Personal pensions continue to exist today, and now fall into the post- Finance Act 2004 framework of registered pension schemes.

1989 saw the introduction of self invested personal pensions (SIPPS) enabling the SIPP member to have a much wider degree of investment control and not merely be limited to the funds offered by a typical life company provider.

Tax relief and personal pensions

[1.11]

Member contributions to personal pensions are paid net of basic rate tax, which is reclaimed by the personal pension provider. Any higher rate income tax relief is claimed through the members self-assessment tax return. Employers are also allowed to make personal pension contributions, which subject to the normal rules on deductions, will be allowable as a business expense. Retirement annuity contributions are generally paid gross with tax relief given through the self-assessment return. Retirement annuity policies could not accept employer contributions.

Personal pensions offered contracting out of the State Second Pension (S2P). Previously they were used to contract out of the S2P predecessor known as the State Earnings Related Pension Scheme (SERPS). This meant that in return for sacrificing the additional component of state pension provision it was possible for personal pensions to receive a rebate of the members national insurance contributions. RAPs cannot be used for contracting out.

Significant tax incentives were offered to encourage contracting out through personal pensions as a means of partially privatising state pension provision. The name given to personal pensions that were capable of being used for contracting out is 'appropriate personal pensions'. These provide 'protected rights', the name given to the rights derived from the national insurance contribution (NIC) rebates which are invested in them.

The evolution of personal pensions and retirement annuities until April 2006

[1.12]

Finance Act 2000 greatly widened the eligibility rules for personal pensions, but left those for RAPs unchanged. The following rules applied to personal pensions from 6 April 2001:

Individuals who were not members of an occupational scheme were eligible to join a personal pension scheme provided they were:

- Aged less than 75, and:
- Either resident and ordinarily resident in the UK at some time in the year the contribution was made, or
- A Crown servant or the spouse of a Crown servant.

The effect of this wider eligibility meant that a person who was not a member of an occupational scheme could become a member of a personal pension scheme if they had non-pensionable employed earnings, self-employed earnings or no earnings whatsoever. Contributions of up to the 'earnings threshold' (£3,600 gross) could be paid to the personal pension of anyone who satisfied the eligibility criteria, regardless of their level of earnings. Personal pensions could therefore be arranged for minor children or non-working spouses.

From April 2001 members of occupational schemes (but excluding controlling directors) could also become members of personal pension schemes with respect to the same employment (a process known as 'concurrency') in the following circumstances:

- If the individual was either resident and ordinarily resident in the UK, or was overseas as a Crown Servant or as the spouse of a Crown Servant,
- If the individual was not, and had not been a controlling director of any company at any time in the tax year or in any of the five tax years preceding it and
- The individual had P60 remuneration not exceeding the remuneration limit (£30,000 in 2001–02 to 2005–06) for the year of contribution.

There were four other circumstances in which an occupational scheme member was eligible to become a member of a personal pension scheme:

(i) The occupational pension scheme offered only death-in-service benefits, or

(ii) The occupational scheme was unapproved, or

(iii) The personal pension scheme was used solely for the purpose of contracting out of S2P (or, prior to 2001–02, SERPs). These arrangements were commonly known as 'rebate only personal pensions'

(iv) The personal pension was used solely to receive transfer payments, i.e. no contributions are made.

Maximum contributions to personal pensions were a percentage of net relevant earnings (NRE), as shown in Table 2 for the final year of operating these limits in 2005–06.

Table 2: Maximum contributions as a % of NRE

Age on 6 April in tax year	Maximum percentage of NRE	Maximum contribution in 2005–06*
%	£	
35 or less	17.5	18,480
36–45	20.0	21,120
46–50	25.0	26,400
51–55	30.0	31,680
56–60	35.0	36,960
61–74	40.0	42,240

* Based on an earnings cap of £105,600 in 2005–06

For personal pensions started before 6 April 2001, the maximum contribution to provide life cover through a term assurance policy was 5% of net relevant earnings, in line with the earlier provisions associated with retirement annuity policies.

For personal pensions that began on or after 6 April 2001, the maximum contribution in any tax year that could be used to provide life insurance cover through a term assurance policy was changed to 10% of the contributions made towards retirement benefits. The earnings cap applied and the term assurance contribution again counted towards the overall contribution limit.

The purpose of this change was to put an end (so far as future arrangements were concerned) to the concept of people using the benefit of pensions tax relief to acquire life insurance protection without there being any form of pension contribution destined to provide for retirement benefits.

An employer was able to pay contributions to an employee's personal pension:

- In respect of the employee's net relevant earnings regardless of whether the employer provided those earnings.
- Where the employee was a member of the employer's occupational scheme and was also eligible to be a member of a personal pension scheme under the concurrency rules under which the employer could also contribute.

Where an employer did pay such contributions the employee was not liable to tax on the benefit of the contributions paid to the personal pension by the employer and National Insurance contributions were not charged on the pension contributions.

However employer contributions could not be 'carried back' to the previous tax year and employee and employer contributions were aggregated when assessing whether the maximum contribution limits had been breached. Employer contributions were paid gross.

Personal pensions and retirement annuities compared

[1.13]

The percentage of earnings that could be paid into RAPs above the age of 35 was lower than the maximum personal pension contributions, as Table 3 shows:

Table 3: Maximum contributions to retirement annuities

Age on	Maximum	Maximum contribution
6 April	percentage	greater than personal
in tax year	of NRE	pension for earnings over
%		£
35 or less	17.5	105,600
36–45	17.5	120,686
46–50	17.5	150,857
51–55	20.0	158,400
56–60	22.5	164,267
61–74	27.5	153,600

There were various other differences between personal pensions and retirement annuities which included:

- Wider eligibility rules introduced for personal pensions from 6 April 2001 did not apply to

RAPs.

- The earnings threshold (see above) of £3,600 did not apply to RAPs.
- Contributions to a RAPs were also based on net relevant earnings, which were defined slightly differently from those for personal pensions.
- The earnings cap did not apply to RAP contributions.
- Tax relief on RAP contributions was not available by deduction at source. An individual could therefore receive the benefit of basic rate tax relief more rapidly with a personal pension than a RAP.
- An employer could not make contributions to a RAP.
- A RAP could not be used for contracting out of the State Second Pension (S2P) previously SERPS.
- A RAP could only take transfers in from other RAPs, not from personal pensions.
- Up until the end of the 2005–06 tax year the tax-free lump sum available at maturity from a RAP was often less than the maximum 25% of the fund that could be taken from a personal pension. The exception was if the RAP policy contained guaranteed annuity rates of greater than 11.11%.
- The tax-free cash sum was limited to £150,000 per policy for RAPs taken out after 16 March 1987.
- Pension benefits from a RAP could normally only start to be taken from the age of 60.
- RAPs could not provide pension benefits without the purchase of an annuity, unless a transfer was first made to a personal pension.

For individuals who had a retirement annuity policy already in existence meant by July 2008 there was a highly complex potential interaction of PP and RAP contributions.

For example where RAP and personal pension contributions were made in the same year, they were added together to determine the maximum possible contribution, but the personal pension limits applied for any year in which personal pension contributions were made.

Thus even a very small contribution to a personal pension in respect of a particular tax year had the effect of imposing the earnings cap on the calculation of the total allowable pension contributions for that year. For these purposes, a personal pension term assurance policy premium had the same effect as a pension contribution.

There is probably no better example of the lunacy that the pensions tax rules had come to. The purpose of retirement annuities and personal pensions was identical and yet the putting in place of personal pensions whilst maintaining the retirement annuity regime, created a totally unnecessary degree of complexity.

The approach to Finance Act 2004

[1.14]

It is no wonder therefore that by the time we reached the end of the old millennium the position with regard to pensions tax law generally had become untenable. As the scope of the contracted out legislation associated with pensions is beyond the scope of this book except where it directly interacts with tax legislation we have not covered the additional complexities associated with this.

Suffice to say that the position had become one where it was impossible to have a clear understanding of how the entire pension system worked. There were literally thousands of pages of legislation, guidance, statutory instruments, practice notes, updates etc, and many instances the rules just seemed contradictory and illogical.

It was therefore decided that simplification was required.

In December 2002, the then Labour Government published proposals for a radical simplification of the tax regime for pensions. Following consultation, legislation was introduced in Finance Act 2004 and came into force on 'A-day', 6 April 2006.

There were actually three documents published on 17 December 2002:

- Simplifying the taxation of pensions: increasing choice and flexibility for all (a consultation document issued jointly by HM Treasury and the Inland Revenue);
- Simplicity, security and choice: Working and saving for retirement (the Green Paper);
- Simplicity, security and choice: technical paper (this paper considered the detailed technical aspects of the proposals set out in the Green Paper).

In the consultation document HM Treasury set out that there were no fewer than eight different tax regimes governing pensions. It was stated that

> '"As a result, pensions tax relief has become so complicated that people are put off saving for retirement and employers have become reluctant to sponsor workplace pensions. The complex rules add to the costs faced by individuals, employers and pension providers, and distort the advice people get. So they restrict what people actually save for their retirement. And that can mean they are disappointed with the income they achieve in retirement."'

The Government therefore proposed to reform the system, introducing a single set of rules stating that:

> '"All pension saving after implementation will follow a single set of rules which will apply to saving in all kinds of pension schemes. And there will be a single set of simple rules about how pension savings are turned into benefits."'

The Government proposed a 'clean break' with effect from a given date to be known as A-day. All pensions saving after A-day would follow a single set of rules that will apply to savings in all types of pension scheme.

The principles set out in the Green paper were:

(1) A single lifetime limit on the total capital value of pension saving that would attract

favourable tax treatment with indexation broadly in line with price inflation

(2) If the value of an individual's overall pension fund exceeded the lifetime limit then a 'recovery charge' would apply.

(3) Pension rights built up before A-day to be valued and converted into equivalent rights under the new regime. The Government said that existing rights built up under current tax regimes would be 'respected'.

(4) Tax relief at the individual's marginal income tax rate to be available on pension contributions.

(5) An annual limit on tax relievable inflows to an individual's pension fund – both contributions to any defined contribution scheme and growth in pension rights in defined benefit occupational schemes. Any 'inflows' above the annual limit to be subject to an income tax charge.

(6) No restrictions on the number or types of pension scheme to which an individual may contribute.

(7) A single, consistent set of rules about the delivery of pension benefits would be introduced.

(8) A maximum tax free lump sum set at 25% of the capital value of pensions savings.

(9) When an individual dies before taking benefits, the whole value of their pension funds could be paid as a tax free lump sum, except for any recovery charge tax on payments above the lifetime limit.

A year later on 10 December 2003 the Government issued a further substantive document: 'Simplifying the taxation of pensions: the Government's proposals'. This developed the ideas of the 2002 consultation document and painted in more of the detail that eventually we saw enacted in the 2004 Finance Act. Implementation date 'A Day', was 6 April 2006. By then the word 'simplification' in this context had already more or less disappeared.

The key elements that were introduced from 6 April 2006 and how they have evolved and changed since then will be explored during the remainder of this book. The words from 2002 may return to haunt:

> '"pensions tax relief has become so complicated that people are put off saving for retirement and employers have become reluctant to sponsor workplace pensions".'

The five pillars of reform

[1.15]

Originally there were five 'pillars' for the new regime for 'registered pension schemes' which may be set out as:

(1) An annual allowance for tax privileged pension savings. This started out at 100% of earned income subject to a maximum of £215,000 in tax year 2006–07, increasing in £10,000 increments to £255,000 in tax year 2010–11. (See table 4)

(2) A lifetime allowance limiting the extent of tax privileged pension savings. This started off as £1.5 million in tax year 2006–07 increasing progressively to £1.8 million in tax year 2010–11. (See table 4).

(3) A single set of investment rules applicable to all registered pension schemes.

(4) More flexible rules in relation to death benefit provision and the abolition of the compulsion to buy an annuity or to have a secured pension.

(5) Transitional arrangements designed to effectively 'shoehorn' the existing tax regimes into the new unified regime so that no one would be disadvantaged.

The annual allowance and the lifetime allowance as they operated until 5 April 2011 are set out in below:

Table 4

Tax Year	*Lifetime allowance*	*Annual Allowance*
2006–2007	£1,500,000	£215,000
2007–2008	£1,600,000	£225,000
2008–2009	£1,650,000	£235,000
2009–2010	£1,750,000	£245,000
2010–2011	£1,800,000	£255,000

It was apparent from the outset to many of those in the pensions industry at the time that these amounts were set at levels that were far too generous in particular so far as the annual allowance was concerned. For a self-employed individual for example earning £100,000 a year we changed from a situation where tax relievable pension contributions could have been as low as £17,500 to one where they were now able to contribute up to £100,000 with income tax relief on the entirety.

HMRC estimate the net annual cost of tax relief on registered pension schemes for 2011–12 to be £23.9 billion after taking account of the tax collected on pensions in payment. The overall cost to the Exchequer of the tax privileges provided to registered pension schemes is about 2.4% of GDP.

The financial crisis of the period 2008 onwards led to the UK Government to taking action to reduce the deficit and it was announced in 2010 that the cost of pensions tax relief was unacceptable and needed to be reduced. Proposals were therefore set out with the objective of reducing the cost of pensions tax relief by between £4 billion and £5 billion. These were implemented through provisions introduced in Finance Act 2011.

The most important change introduced was a reduction in the annual allowance to £50,000 in 2011–12 which (I wrote in August 2012) 'will not be reviewed for some years'. Although the £50,000 annual

allowance continues to apply in 2012–13 and 2013–14, the annual allowance reduces to £40,000 from 2014–2015. According to the Government this 'supports the objective of a system of pensions tax relief that is fair, affordable and sustainable'. The more cynical may however have spotted a trend.

Although protection was introduced for those with larger funds the lifetime allowance has also been reduced. The lifetime allowance with effect from April 2012 was reduced to £1.5 million, and (once again I wrote in August 2012) 'this will not be reviewed for a considerable period of years'. The Government announced on 5 December 2012 that to 'support its objective of a system of pensions tax relief that [once again] is fair, affordable and sustainable', for 2014–2015 onwards the lifetime allowance would be reduced from £1.5 million to £1.25 million.

In the remainder of this book we will look at the UK pensions taxation system as it currently works in detail. The purpose of this first chapter has been to set out how it is that we arrived where we are now and indeed that there is a continuing journey. How that journey might continue is considered in the final chapter of this book.

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