Flexible friend

OMB Personal tax

01 July 2015

John Kelly and *Martin Jarvis* consider the pension flexibility changes and their impact on SIPPs and SSASs

Key Points

What is the issue?

After constant legislative change and the mixed press pensions have received, individuals have been put off paying more than the bare minimum into schemes

What does it mean for me?

The recent changes mean that your pension scheme is now incredibly flexible with 25% of the pot usually available tax-free and 75% subject to income tax when you choose to draw it. This is on top of the already flexible investment rules governing self-invested personal pensions (SIPPs) and small self-administered schemes (SSASs), allowing individuals more control of their pension assets

What can I take away?

Pensions are now one of the most tax-efficient vehicles in which to invest. Growth is tax-free, contributions receive tax relief either personally or through a company and the benefits can be passed on to the beneficiaries, normally tax-free, if the pension holder dies before age 75

Historically, mere mention of pensions left the listener glazed over, searching for anything else to talk about. But since the 2014 Budget announcement that individuals with defined contribution schemes can take whatever they require on retirement from their pot each year with no restriction, the industry has been at the forefront of many news reports and comment.

Although this is fantastic for pensions generally, these changes represent only a fraction of the flexibilities provided by arrangements such as a self-invested person pension scheme (SIPP) and a small self-administered scheme (SSAS). With full flexibility casting a spotlight on the pensions industry, SIPPs and SSASs have the chance to showcase these wider flexibilities and push themselves to the forefront of many people’s minds, not just on retirement planning, but also business planning throughout life and estate planning on death.

A question asked now is whether the reform is applicable to all. Are all defined contribution products affected similarly? Can a personal pension plan work the same as a SIPP or SSAS? By considering how these schemes function, it should become clear that the recent changes add flexibility to more restrictive arrangements, while increasing that for SIPPs and SSASs.

From humble beginnings

The SIPP industry has grown immeasurably since the first one was established in 1990. From a peripheral product offered by three providers, the schemes now account for about 15% of the UK personal pension industry. SSASs have a longer history, tracing their origin to FA 1973 which allowed controlling company directors to use their pension schemes more flexibly than they could with a straightforward defined benefit plan.

Over time, legislation has gradually increased this flexibility; however, there were always noticeable differences between the two schemes. SSAS seems more attractive to maximising company contributions, with SIPP offering a great benefit choice. This was until April 2006. The catchily titled ‘A-Day’ homogenised much of the pension tax system, along with most SIPP and SSAS rules. Since then, both schemes have been able to claim themselves as the most flexible in the marketplace.

A trust basis

SSIPs and SSASs are trust-based and the individual is usually appointed as a trustee and a member of the scheme. From day one, there is greater control over their pension fund which a personal, stakeholder or even online SIPP cannot compete with. It means the individuals can tailor their investments, right the way down to bank accounts, all to create a bespoke arrangement that meets their needs.

Further, from purchasing commercial property, buying unquoted shares, bank borrowing, purchasing shares in a connected company and operating a plethora of different drawdown options, or using the funds to buy an annuity, this picture of flexibility begins to paint itself. Add in the inheritance tax benefits, tax-free investment growth (apart from the 10% dividend tax credit), as well as the flexibility of how beneficiaries can access the pension, and the painting begins to look like a masterpiece.

Differences

There are slight yet important differences between the two schemes. SSASs can own only up to 5% of the scheme’s value in a sponsoring employer (up to 20% if there is more than one sponsoring employer, that is, 5% into four companies), whereas SIPPs share ownership is unlimited – see ***Example 1***.

Example 1 – Connected share purchase via a SIPP

The scenario: ABC Limited is issuing new shares to raise funds for company expansion, and the director has heard that his SIPP can purchase the business's shares.

The solution: The SIPP can purchase the company shares using an open market valuation of the share price from the total value of the scheme if the trustees wish. However, as with all connected transactions, some prior considerations need to be made. These include:

1. A detailed analysis of ABC Limited would need to be conducted to ensure there is no 'taxable property' held within the company. This generally refers to residential property and tangible moveable property such as company cars. If there is any, the scheme, except in limited circumstances, would be deemed to have an indirect interest and tax charges would apply.
2. Although the SIPP can invest up to 100% of its assets, is this really prudent? With unquoted shares having the potential to be very high risk anyway, this risk is exacerbated by the director owning them through his entire pension scheme. For example, if the company falls into difficulty, so does the pension scheme.

In contrast, SSASs can lend scheme monies to the sponsoring employer(s) via a 'loanback' – see ***Example 2*** – which a SIPP cannot do.

Example 2 – Loanback via a SSAS

The scenario: It has been two years since ABC Limited completed a property purchase through the SSAS and trading has been good. It is now looking to invest in future development of the firm's business but has limited cash resources. The company has been making maximum contributions to the SSAS and as such has little or no cash reserves. ABC requires £500,000 to complete the development. The SSAS is valued at £1 million with £250,000 in property and £750,000 in cash.

The solution: Because the fund is an SSAS the scheme can lend up to 50% of its net asset value to a sponsoring employer. There are conditions to be met:

1. the loan must be for no longer than five years and no more than 50% of the net asset value of the scheme;
2. repayments must be via equal capital and interest payments, paid at least annually;
3. security must be taken in favour of the scheme on an asset of at least equivalent value to the loan plus interest as a fixed first legal charge; and
4. a rate of interest must be applied which is at least equivalent to that specified by HMRC.

   In the above scenario, the scheme could lend £500,000 to the company using the above conditions to ensure the loan is on an arm’s-length basis.

Funding flexibility

Company contributions are deductible against profits, and they can be spread between accounting periods creating a flexible way of funding for retirement. There is also the option to ‘carry forward’ three previous years’ worth of contribution allowances to add to the pension pot if an individual meets the requirements. Therefore, including the current annual contribution limit of £40,000, an individual has the potential to pay up to £180,000 in a current pension input period and generate a sizeable pension pot relatively quickly.

Full flexibility

Now for the elephant in the room: full flexibility. The changes have divided opinion. Some commentators think it is a bad thing and encourages scheme owners to spend recklessly, exhaust their pension pot and go calling on the state to fund their income for the rest of their life. On the other hand, many also see this as a welcome move given that the annuity market, which some scheme owners were forced to use, provided such poor value to customers and had not worked in the modern economic climate for many years. The failures were partly down to the economics of the payments but also, because individuals are living longer, payments offered by providers needed to be lower to maintain sustainability.

A good way to look at the changes is to compare potential effects on individuals at all points of the pension savings spectrum, be that a small or large pension pot. The average pot is about £40,000. When factoring in tax-free cash (25% of the fund value) and with the remainder being used to purchase a single-life annuity with no guarantees, the weekly gross payment is about £32.

In this scenario under the previous legislation, a forced annuity purchase would probably occur, benefiting no-one. The individual has a small income but with very limited options on passing funds to the next generation, plus the Treasury receives a small tax take depending on how long the member lives.

Now, under flexi access, this pot can be drawn out in its entirety with the sum being put to good use. The member still receives their 25% tax-free, with the remaining 75% being subject to income tax, but it is intended that the residual balance will grow to provide for them or even pass on to future generations. Equally, the Treasury obtains a relatively bigger tax take upfront.

For members with larger pots, it is no giant leap of faith to assume they have consciously built a sizeable value. Would they really spend all of this if this is all they have to live off in their retirement? Arguably, not.

The problem of individuals simply withdrawing all of their funds should be cut off at outset because any practitioner worth their salt should be taking into account numerous factors before advising on the sustainability of those payments.

For instance, if a member has only a £100,000 pot at age 65 to see them through retirement, they should be advised against taking all of this out. Equally, if the same member has a large defined benefit scheme paying a healthy pension to cover his needs, withdrawing the £100,000 pension makes more sense.

Of course, there will be teething problems with this type of change. For example, if an individual only takes one payment like this each tax year, they are more likely to be put on an emergency tax code and be landed with a higher tax bill. Therefore, a higher gross figure is needed if they need a set level of income.

It doesn’t stop there…

Flexible access has gained a lot of coverage, although the jewel-in-the crown is in the changes to death benefits.

These changes can be seen as a microcosm of pensions industry changes as a whole over recent times. From forced annuity purchase at age 75 and the penal tax on death of up to 82%, the initial payment of benefits on death was a real drawback to pension funds. Gradually, changes have been put in place that now rival other pension scheme flexibilities. Removing the compulsory need to purchase an annuity at 75 allows individuals a greater say on where their hard-earned pension pots would be transferred to on death.

Before April 2015 the tax rate on death was 55% for lump sum benefits if the individual died after age 75, or left behind crystallised funds. The dependent paid tax at their marginal rate if benefits were taken as income. No tax was payable if an individual had not taken their tax-free cash before age 75 and funds were paid out within two years. Already, the differences from the previous 82% tax regime are stark.

However, in September 2014, the chancellor announced that an individual who dies before age 75, regardless of whether they have taken benefits, can pass on the pension fund to their beneficiaries tax-free. This can be as a lump sum or income. Over age 75, the tax is 45% on lump sums or the individual's marginal rate if taken as income. From 2016 the plan is to reduce the 45% tax to the recipient's marginal rate.

The changes do not stop there. The beneficiaries can be anybody the deceased has nominated, so these are not limited to family members. On the death of the individual who inherits the pension, they can again pass this on using the new rules – crucially using their age at the time – see ***Example 3***.

> **Example 3**
>
> A member dies aged 73, having taken income from the fund and leaving a pot of £200,000 for his wife, aged 62. Since the member was below age 75, she can enjoy a tax-free income. The widow dies, also aged 73 and had taken a modest income from the fund, although the value is still at £200,000. Because she is under 75, this fund can be passed to their son tax-free.

The future…

As with any industry, there are challenges ahead. How will flexi access be received? Some providers at present are unwilling to offer the option, deeming it too high risk and confusing for members. How will full flexibility affect divorce and bankruptcy cases? It was a widely held view that a pension scheme was secure under bankruptcy; however, will the fact a member has the ‘ability’ to draw the whole of their pension pot in one go leave schemes open to attack? The changes also add the potential for further layers of complexity. Yes, the changes are easy to understand, but they affect only some schemes – other forms of drawdown and annuities remain, so individuals with existing pensions may believe they have full flexibility when they do not.

Overall, SIPPs and SSASs have come a long way since those small schemes, dwarfed by the big insurance company funds. From niche schemes from which only some individuals may benefit, the pension funds are now so well structured they can be used in many ways to help individuals with issues they, or a business, may be facing. Equally, they have the option of being used as a conventional retirement vehicle. Further, combine this with other structures, such as new individual savings accounts (NISAs), spousal bypass trusts, trust planning in general as well as venture capital trusts and enterprise investment schemes, the options on creating a solution tailored to the client’s circumstances are clearly there.

Arguably, the key to this is flexibility, without which the schemes would be no different from a stakeholder scheme; but, by being flexible, they are transformed into a powerful planning tool before, during and after retirement.