Pensions for business owners

Anyone setting up or running a company must be able to prioritise their time and resources, which might see pension planning pushed down the agenda. But creating a savings plan is one way to ensure a secure and comfortable retirement.

Changes to the tax regime in the last two years have made pensions saving simple, so the sooner you invest in a pension the more you will have available to make the most of your retirement.

This briefing outlines:

- The benefits of committing to a pension scheme.
- Using your share of the business to help fund your retirement.
- Other forms of pension funding.
- Alternatives for retirement financing.
- Planning for your retirement.
- Where to get advice.

1 Why act now?

Rising life expectancy has put pressure on retirement planning, highlighting the real danger that you might outlive your savings. By **taking action** early on, there is a greater chance you will be able to adequately fund retirement.

1.1 Decide how much you need to save to live **comfortably** in retirement.

- Identify your ideal annual income using a pension calculator (see **6.1**) and work out what you need to save to achieve that.
- Allow for inflation when working out targets.
- For example, a 40-year-old aiming for an annual retirement income of £30,000, retiring at age 60, would need to multiply £30,000 by 25 (£750,000).

1.2 The **earlier** you start, the less expensive it is to save.

- A 50-year-old who starts saving for their retirement at the same time as a 40-year-old, may need to save nearly three times as much every month to secure the same level of pension saving.

2 How to fund your retirement

Since the advent of a simplified tax regime (see box, page 2), business owners can make much more of their pension arrangements.

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2.1 By setting up a Small Self-administered Scheme (SSAS) company owners can use the pension fund to lend money or to **invest** in the business.

- SSASs fall under the same tax regime as other registered schemes (see box, page 3) and offer the same advantageous tax breaks.
- Employer contributions are unlimited and deductible against corporation tax.
- SSASs can hold up to five per cent of the sponsoring employer's shares.
- A SSAS can lend money to the employer provided the loan does not exceed 50 per cent of the net value of the scheme's assets.
- SSASs can borrow to invest or to pay a member's benefits. But borrowings must not exceed 50 per cent of the scheme's assets.

The new tax regime

Since A-Day on 6 April 2006, there have been significant changes to the pensions tax regime. The simplifications include:

- Individuals will be allowed a tax-free standard lifetime allowance (SLA) of £1.65 million increasing to £1.8 million in tax year 2010/2011.
- The total value in all registered schemes will be tested at the time benefits are taken or at age 75. Any excess above the SLA will be taxed at 55 per cent.
- Tax-free lump sums of up to 25 per cent of total pension savings can be drawn.
- Benefits may be drawn after age 50 (rising to age 55 in 2010) but all lump sums must be drawn by age 75.
- Members do not have to retire or leave service to take pension benefits.
- There is no statutory requirement to buy an annuity.
- There are no restrictions on transfers between pension schemes.
- Individual contributions of £3,600 or 100 per cent of annual earnings, whichever is higher, will receive full tax relief subject to the annual allowance.
- The annual allowance for individual contributions will be £255,000 by tax year 2010/2011. Contributions in excess of the allowance will be subject to tax.
- Restrictions on the types of investments made by registered schemes are limited. For example, members can invest in residential property, art and antiques.

2.2 Pension funds can now form part of an **exit strategy** for business owners.

- In the final year of work before retirement there are no limits on the amount you can pay into a pension.
- If you plan to sell your business to fund your retirement, paying a large contribution into your scheme will both provide a pension in its own right and reduce the capital gains tax on sale of the company.
- However, you cannot exceed the lifetime allowance without incurring a tax penalty (see box, page 2).

2.3 A pension mortgage is a **tax-efficient** way of repaying a loan on a property.

- You make interest-only payments on the mortgage while at the same time paying into a pension. At the end of the mortgage term, you use the tax-free lump sum from the pension to pay off the mortgage.

3 Forms of pension funding

3.1 Executive Pensions Plans (EPPs) are defined as **contribution plans** provided by the employer and run by a life assurance company.

- Employees are not liable to income tax or National Insurance contributions (NICs) on payments made to an EPP.
- Contributions are subject to tax relief limitations (see box, page 2).
- Members can transfer existing plans into their EPP.
- The frequency and amounts payable to an EPP are usually flexible.

3.2 Self-invested Personal Pensions (SIPPs) are similar to standard personal pensions but allow the member greater investment **freedom**.

- SIPPs are governed by the same tax, contribution and eligibility rules as personal pensions.
- SIPP investors can control their investment strategy and hire a fund manager or broker to carry out investment decisions.
- SIPPs are run under trust law although the member can be the trustee if the plan is overseen by an independent administrator.
- Administration costs can be high.

3.3 Pensions Salary Sacrifice allows employees to exchange earnings for **non-cash benefits** which means both employer and employee make NI savings.

Types of occupational scheme

A Defined benefit schemes (DB or final salary schemes):

- DB schemes place the responsibility for funding pensions on the employer.
- They promise a pension related to earnings at retirement.
- Employees can hope to retire on two-thirds of final salary, though most will retire on considerably less.
- The schemes are revalued to ensure they still have enough assets to pay pensions far into the future. Asset values are affected by certain factors, particularly stock market performance.
- Market volatility, increasing life expectancy and escalating costs have seen private corporate DB schemes disappear as the main form of occupational scheme in the UK.

B Defined contribution schemes (DC or money-purchase schemes):

- DC schemes place the risk of underfunding on the employee.
- Employees are usually expected to select their own investment strategy for the scheme.
- Most schemes offer a default which most employees invest in.
- They promise a lump sum at retirement with which employees can buy an annuity (see box, page 4), or from which they can 'draw down' cash. For example, withdraw income directly from the pension plan within limits each year, delaying the purchase of an annuity until interest rates are sufficiently attractive (see box, page 4).
- The size of the lump sum (capped at 25 per cent) depends on market conditions, the investment strategy and level of contributions.

C Hybrids/Risk Sharing Schemes are neither pure DB nor pure DC and allow for risk sharing between employer and employee.

- Hybrid schemes include career-average plans and cash balance plans.
- Seen as a compromise between DB and DC, hybrids are gaining a place in occupational pension provision but remain the exception rather than the norm.

- Employee pension contributions are converted into employer contributions which do not incur NI.
- The employer can pass NI savings to employees as a bonus contribution to the plan.
- Pension salary sacrifice can see contributions rise by 30 per cent at no extra cost to the employer.

3.4 Funded Unapproved Retirement Benefit Schemes (FURBS)/Employer-Financed Retirement Benefits Scheme (EFRBS) were set up to provide **benefits** for employees earning more than the salary cap.

- The tax reforms in 2006 have replaced maximum salary with a lifetime allowance making FURBS/EFRBS less relevant.

4 Options for retirement financing

Pensions may be the most tax-efficient way to pay for your retirement but they are not the only option.

4.1 Selling property at retirement offers a possible **lump sum** that could be used as a pension.

- Using property as a pension means you can access the money before normal retirement age.
- You have more control over the asset.
- You are reliant on favourable property prices and the ability to sell your home when you want to retire.

4.2 Individual savings accounts (ISAs).

- All withdrawals from an ISA are tax free and there is no obligation to buy an annuity.
- Money can be accessed at any time.
- ISAs could be beneficial for basic rate taxpayers, but higher rate taxpayers are likely to better off in a pension.

5 Retirement planning

5.1 Choosing the right time to retire is **crucial** and is often determined by how you have funded your pension.

- If you are a member of a final salary scheme, your only options are to take a tax-free lump sum and an income. The income is guaranteed until you die.

- Defined contribution members can take a tax-free cash sum of 25 per cent of the total fund and either choose an annuity or income drawdown.
- The new rules make it possible to claim a pension but continue to work.
- By taking phased retirement, which splits the total retirement fund into segments, individuals can stagger the purchase of annuities up to age 75 and keep the unclaimed assets invested.
- If you are selling the business to pay for your retirement, seek professional advice on the exit strategy.

5.2 When seeking a professional adviser, make sure they are **experienced** in advising on the specifics of pensions for business owners.

Annuities

Whether a pension is to be drawn from a defined benefit or a defined contribution scheme, normal practice is for the assets to be **converted** into an annuity.

- The scheme member can generally take up to 25 per cent of their pension pot as a tax-free lump sum. The rest must be used to provide incremental pension benefits.
- The size of the benefits will depend on the value of the assets at retirement and on the prevailing interest rates.
- When interest rates are high, pensioners will get a comparatively high return on their assets. When they are low, the return will be poor.
- Although in theory interest rates will be high when asset values are low, this will not always be the case and it is hard to predict how significant the benefits from an annuity will be.
- It is possible to offset these problems by postponing taking an annuity and 'drawing down' capital from the fund instead.
- With all personal pensions, it is now possible to do this until the age of 75, and with most personal pensions it will be possible to carry on doing it thereafter. With Personal Accounts, however, annuities will have to be purchased no later than age 75.
- Scheme members should shop around for the best annuity rate using the Open Market Option and not automatically opt for the product offered by their pension provider.

6 Getting advice

6.1 Getting the best out of your pension requires **professional advice,** particularly in the final stage of retirement or before selling your business. Before contacting a fee-based adviser, information can be obtained from:

- The National Association of Pension Funds (www.napf.co.uk; 020 7808 1300).
- The Pensions Advisory Service (www.pensionsadvisoryservice.org.uk; small business helpline 0845 602 7021).
- The Pensions Regulator (www.thepensionsregulator.gov.uk; 0870 606 3636).
- HM Revenue & Customs (www.hmrc.gov.uk/pensionschemes/index.htm; 0115 974 1600).
- Online pension calculator (http://www.moneymadeclear.fsa.gov.uk/tools/pension_calculator.html).

6.2 Ensure your professional adviser is **regulated**. Contact the Financial Services Authority to check (www.fsa.gov.uk).

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