October 2011

TRANSITIONAL RETIREMENT INCOME PLANNING

Pensions/Employment/Taxation and Benefits

EMPLOYERS CAN NO LONGER OPERATE A DEFAULT RETIREMENT AGE, MAKING SUCCESSION PLANNING MUCH MORE DIFFICULT. BY EXPLORING TAX PLANNING OPPORTUNITIES WITH STAFF, EMPLOYERS CAN GAIN A USEFUL INSIGHT INTO THEIR EMPLOYEES' RETIREMENT PLANS, WHILST GENERATING FINANCIAL BENEFITS FOR BOTH PARTIES.

The commercial problem

With the abolition of the statutory default retirement age, employers may in future find that it is much more difficult to plan for the retirement of their employees. This is because employees may choose to keep their retirement plans secret from their employers in order to avoid being sidelined in the run-up to their anticipated retirement (with the resulting loss of flexibility should they later decide that they wish to continue working for a longer period).

It is therefore likely that employers will begin to see increasing numbers of employees simply giving the contractually required notice before retiring. This will be a particular problem for employers where the employees are in highly skilled or managerial positions.

The benefits for employees and employers

Most employees who pay income tax at the higher rate of 40% will expect to pay tax at the basic rate of 20% on their pension once they retire. By planning a year or two in advance of retirement it is possible to defer income so that it is taxed at the marginal rate paid in retirement rather than at the higher, pre-retirement level.

Deferring income in this manner can provide extra cash in the early years following retirement to help employees manage the reduction in overall income that usually occurs when they cease work. By facilitating such planning, employers can gain a useful insight into the retirement intentions of their employees, as well as saving NICs and improving cash-flow.

Deferring income into retirement

There are three basic methods of deferring employment income into retirement:

- making contributions into a registered or unregistered pension plan;
- agreeing to defer receipt of employment income, such as bonuses; and
- adjusting the terms of employee share plans.

These methods work particularly well for employees who intend to retire at or near state pension age.

Registered pension plans

In the past, making large pension contributions into a registered pension plan in the last few years of employment would have been unattractive to many employees because of restrictions on the subsequent withdrawal of these funds. However, large contributions (within the annual allowance of £50,000) may now be a more attractive option due to the new "flexible drawdown" rules contained in the Finance Act 2011.

Under flexible drawdown, an individual who is 55 or over will potentially be able to draw a lump sum from his pension savings, without a limit on the amount withdrawn, if he has sufficient annual income from the remainder of his retirement savings to meet the "minimum income requirement" (MIR). The MIR is currently set at £20,000 and can be met from most pension sources, including state, occupational and personal pension plans. Lump sums drawn down will be taxed at the individual's marginal rate of income tax in retirement (although it is still possible for the member to draw a tax-free "pension commencement lump sum" of typically 25% of the value of the pension savings in the plan).

If an employee will pass the MIR test and qualify for flexible drawdown, then paying large pension contributions in the last few years before retirement may be attractive. Tax relief will be available on those pension contributions and NIC savings can be made if the contributions are paid via a salary sacrifice arrangement. The employee can later withdraw these funds from the pension scheme by means of flexible drawdown when he has retired and is likely to be subject to lower rate of income tax. Overall, by converting income into pension contributions and using flexible drawdown to access those funds at a later date the net receipt is potentially increased by over 45%.

For employers who are looking to de-risk their defined benefit pension plans, there are some interesting interactions between an employee's wish to take advantage of flexible drawdown and the need for the employee to transfer some or all of his benefits into a defined contribution pension plan to achieve this.

Unregistered pension plans

If an individual intends to make pension contributions which will result in his pension savings exceeding the annual allowance of £50,000, the individual may be able to channel the excess through an unregistered pension plan. These arrangements (known as Employer Financed Retirement Benefit Schemes or EFRBS) are now subject to disguised remuneration rules, but remain viable if structured correctly. Please see our separate publication entitled "*Pension saving in excess of the annual allowance*" (August 2011).

Cash payments/bonuses

This is a more straightforward form of income deferral. Employees can agree with their employers to defer parts of their remuneration for a set period of time so that the income is received during tax years following their retirement. This can be done with basic salary but is more appropriate for bonuses.

Assuming that income is deferred from a period in which it would be taxed at 40% into a period in which it would be taxed at 20%, the net receipt may be increased by over 35%. For the employer, there is a cash-flow advantage, partially off-set by the delay in the corporation tax deduction.

Employee share plans

Employee share plans are usually set up or operated so that "good leavers" receive their shares or exercise their options within a limited time after leaving employment. This has the effect of concentrating income around the retirement date, which is not very tax-efficient for higher-rate taxpayers who anticipate being basic-rate taxpayers in retirement.

There are a number of ways that these plans can be adapted to provide extra flexibility to improve the tax position of retiring employees and greater predictability from the employer's perspective. However, the variety of the types of plans used and issues surrounding age discrimination and the new disguised remuneration legislation mean that these changes must be approached on a plan by plan basis.

Further Information

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