



15 October 2007

Taxation of Pension Schemes

Income Tax (Pensions) Bill 2007

Proposal Document

Issued by:

Income Tax Division
2nd Floor Government Office
Buck's Road
Douglas
IM1 3TX

THIS PAGE HAS BEEN INTENTIONALLY LEFT BLANK.

TAXATION OF PENSION SCHEMES IN THE ISLE OF MAN

INCOME TAX (PENSIONS) BILL 2007

PROPOSAL DOCUMENT

1. INTRODUCTION

On Budget Day, 20 March 2007, Treasury published its 'Taxation of Pension Schemes - Consultation Response', reviewing possible changes to the taxation of approved pension schemes in the Isle of Man.

Treasury can now provide:

- a.** further detail in respect of the proposed changes;
- b.** comment on regulations needed to support some of the changes;
- c.** a copy of the draft pensions bill;
- d.** an 'amended' version of the Income Tax (Retirement Benefit Schemes) Act 1978; and,
- e.** an 'amended' version of Part 1 and Schedule 5, Income Tax Act 1989.

The amended acts show how the 1978 and 1989 Acts will look assuming that the Bill becomes law without amendment.

2. ABBREVIATIONS

'1970 Act' means the Income Tax Act 1970

'1978 Act' means the Income Tax (Retirement Benefit Schemes) Act 1978

'1989 Act' means the Income Tax Act 1989

'The Bill' means the Income Tax (Pensions) Bill 2007

3. DISCLAIMER

This document, the Bill and the amended acts are for information purposes only. They cannot at this time be relied upon when dealing with the taxation of pension schemes in the Isle of Man.

The Bill will start its legislative passage during the autumn 2007 session, when it may be amended, and will then be subject to Royal Assent. The resulting Act of Tynwald will be made available via the Isle of Man Government website (www.gov.im/infocentre).

4. INCOME TAX (PENSIONS) BILL 2007

a. Approach

A decision taken following the public consultation was that, as far as possible, the 1978 and 1989 Acts should be retained. The Bill will therefore amend, insert or repeal sections in the 1978 and 1989 Acts where necessary.

b. Withdrawal of funds

Clauses 1 & 2 set out how scheme funds will be applied for the benefit of members in retirement. Funds will be used to provide a pension income, which in the case of personal pensions represents a significant change, as they were previously required to purchase an annuity. Annuities may be purchased, but this will be a choice and not a statutory rule. As a result of this new approach, the pension can either be taken in the form of an annuity or by withdrawing income directly from the scheme funds.

The requirement that personal pension scheme benefits must commence no later than the age of 75 is being retained.

Regulations will determine how the withdrawal of income is to be calculated. We envisage two main systems being available: individual actuarial review or the UK Government Actuary's Department (GAD) tables. The regulations will also allow the member to elect, within certain limits, to take more or less than the calculated withdrawal of income. For example, in the UK, for members under the age of 75 pensions can be as high as 120% or as low as 0% of the annual pension determined using the GAD tables.

Members of pension schemes will have different financial needs. Some members will wish to draw the maximum possible pension during lifetime, whilst others will be able to draw the lowest level of pension. The member drawing a 'full' pension will be liable to tax on the amounts withdrawn up to, potentially, the whole of the fund if it is exhausted during their lifetime. Members drawing 'reduced' pensions will also be liable to tax on the amounts withdrawn, but the freedom to reduce the level of pension drawn during the member's lifetime should not result in any additional tax advantage on the member's death.

In the same way that tax is charged on unauthorised payments when a pension scheme is wound up, it is proposed that tax will be charged on any surplus funds remaining when a member dies. The charge will only apply if a pension had commenced before death. The rate proposed by Treasury is 7½% of the total market value of the remaining fund when the member dies; this tax to be paid by the administrators or trustees of the scheme

before releasing the net funds to the personal representatives of the deceased member.

This proposal does not amount to a death or inheritance tax. A person setting up a personal pension scheme is entering into a contract, the 'sole purpose' (referred to again later in this document) of which is to provide the member, and his or her spouse and dependents, with benefits in retirement and on death. The pension scheme provides relief from income tax on the amount of contributions made (if any), exemption from income tax on any investment income received by the scheme and taxation of all payments out of the scheme, other than permitted tax-free lump sums. Having started to receive a pension, the member has entered the taxation phase of the pension scheme and has probably benefited by way of a 30% tax-free withdrawal. In addition, the proposed underlying change in how the fund can be withdrawn will now allow the potential, at least, for surplus funds to be passed on to the deceased member's family, which is not possible under our current system.

This proposal will not affect lump sum payments made before pension commenced. Death in service lump sums (and the equivalent for personal pensions) made in accordance with the rules of an approved scheme or arrangement, within the statutory limits laid down in the 1978 and 1989 Acts, will continue to be tax-free.

c. Permitted investments

The 1978 and 1989 Acts include a definition of 'investment'. Clauses 3 & 4 of the Bill will allow the definition to be extended, or restricted by regulation.

There are two ways to define permitted or prohibited investments. The first is to provide definitions in regulations; the second is to set out in public guidance a number of tests which, if passed, would lead the Assessor to permit the investment under his discretionary authority.

We propose that the public guidance and tests route is appropriate.

The tests will be that:

- i. what is proposed clearly shows duty of care and sole purpose on the part of the administrator;
- ii. the assets (and any arrangements in relation to them) are demonstrably commercial, or what may better be described as on arm's length terms;
- iii. the member(s), and persons connected to them, will not and cannot derive further benefits other than via the sole purpose; and,
- iv. assets can be valued easily by independent third parties.

Applying these tests could result in residential property being acquired by a scheme, provided the relevant benefits on retirement can be financed by selling the property or by using other assets held by the scheme.

d. Trivial commutation

Clauses 5 & 6 set out the provisions needed to introduce triviality in the Isle of Man. In the past, clearance to make payments was given by the Assessor while, more recently, scheme administrators have been able to rely on an Extra Statutory Concession approved by Tynwald in June 2007.

The provisions will limit triviality to those situations where the member's total pension benefit (from all schemes) falls below a prescribed amount. The amount will be set by regulations, and will be reviewed annually as part of the Budget process. The regulations will also set out other factors to be taken into account in determining whether the limit is exceeded.

The regulations will limit access to the triviality option. Members will have to review their total pension benefit and commute all schemes at the same time. If further triviality claims are made, trivial commutation will not be permitted, the member will be required to draw the pension benefits or purchase an annuity.

A payment allowed under the triviality rules will include a tax-free amount, equal to the maximum lump sum payable on retirement, with the remaining amount being liable to tax.

The trustees or scheme administrator will be required to deduct tax from the remaining amount and pay this to the Assessor, this being deemed to have been paid on behalf of the member. The trustees or scheme administrator will be required to provide the member with a notice of the tax deducted, the payment being earned income of the member for income tax purposes.

e. Lump sum limit

Clauses 7 & 8 of the Bill increase the maximum lump sum allowed in commutation of pension to 30%, whilst clause 9 removes the permitted maximum that currently limits the amount of the lump sum to £150,000.

Defined benefit schemes approved under section 1 of the 1978 Act will continue to limit the lump sum based on the 3/80ths rule (but without applying the permitted maximum limit); however, scheme trustees will be able to seek discretionary approval under section 2 of the 1978 Act if the lump sum is to be changed to the new 30% maximum.

Section 44B of the 1970 Act, giving tax-free status to the lump sum paid to the member, is being retained.

f. Early payment of lump sums

Clauses 10 & 11 break the link between the first payment of pension and the commutation of part of the pension, used to pay a tax-free lump sum to the member.

The lump sum could be taken before pension, but not earlier than the earliest date on which the pension could be taken. Payment of the lump sum will be a once only event, and if contributions continue they can only be used to increase the pension.

g. Continuation in employment

Clause 12 of the Bill introduces a new power in section 2(2) of the 1978 Act that will permit the receipt of pension whilst continuing in employment.

h. Contributions – annual allowance, etc.

Clauses 13 and 14 cover the limit on contributions to an approved scheme, the introduction of a minimum allowance and the level of tax relief available.

Complex rules allowing members of personal pension schemes to carry back contributions or to carry forward unused relief are to be repealed. Instead, a new annual allowance will limit the contributions that can be paid into approved schemes and arrangements. The annual allowance will reflect the aggregate of all contributions, whether or not paid by the member, into all schemes and arrangements that the member can contribute to during the year.

The aggregate of contributions includes employer, member and DHSS contributions but it does not include transfers into an approved scheme from another scheme.

The annual contributions allowance will be set at £300,000 for the 2008/2009 tax year and will be reviewed annually as part of the Budget process.

The amount of contributions on which tax relief can be claimed will not exceed 100% of relevant earnings, unless the minimum allowance applies. The minimum allowance will be set at £3,600 for 2008/2009. If the member has relevant earnings of £3,599 or less, relief will be granted in the member's assessment up to a limit of £3,600 by setting the amount of the

contribution against the member's other income in the year (including unearned income and state benefits). If the member has insufficient income in the year to generate a tax liability, they will still be able to make a contribution, but no relief will be available.

The amount of the annual allowance has been set at £300,000 so that most scheme members will no longer be limited in the amount they can contribute in a given year. Where a member does make contributions in excess of the annual allowance, the trustees or administrators will be encouraged to refund contributions in excess of the annual allowance back to the payer. If a refund is not made, the excess contribution will be subject to a 40% non-refundable tax charge payable by the trustees or administrators. The rate of tax matches that already due on certain payments out of 1978 schemes and will act as an inducement not to make contributions exceeding the annual allowance.

The concept of a lifetime allowance, as introduced in the UK, is not being adopted in the Isle of Man. Members of Manx approved pension schemes will be able to make contributions above the level permitted for UK registered pension schemes.

i. Miscellaneous amendments

Clauses 15 and 16 include a number of miscellaneous amendments to the 1978 and 1989 Acts.

One amendment deals with reporting certain events and actions to the Assessor. Such events could include the creation of a new scheme based on model deed and rules, and amendments to a scheme, including changes to the trustees.

We do not envisage the need for all approved schemes to file accounts with the Assessor. It is therefore likely that the current position will be retained, and that accounts, etc. will be required only if the Assessor issues a written notice.

5. International Personal Pension Schemes

Treasury intends that an international personal pension scheme is introduced by the Income Tax (Pensions) Bill 2007. This will:

- complete a 'package' of schemes and arrangements that can be set up and managed in the Island; and
- permit and encourage the transfer of funds from overseas pension schemes.

This will allow non-residents to set up approved pension schemes, and enjoy the same tax status already available for international superannuation schemes approved under section 50B of the 1970 Act.

The draft Bill issued today does not include reference to an international personal pension scheme. A new clause will be added to the Bill before it is passed to the House of Keys for first reading.

6. Further information

If you have any questions or would like any further information please contact:

Richard Carter ATT
Senior Pensions Officer
Treasury, Income Tax Division
Buck's Road
Douglas
Isle of Man
IM1 3TX

Tel: (01624) 685270
Fax: (01624) 685418
Email: Richard.Carter@itd.treasury.gov.im