# THE CHARTERED INSURANCE INSTITUTE

# J05

# Diploma in Financial Planning

## Unit J05 – Pension income options

### April 2013 examination

**SPECIAL NOTICES**

**All questions in this paper are based on English law and practice applicable in the tax year 2012/2013, unless stated otherwise in the question, and should be answered accordingly.**

**Assume all individuals are domiciled, resident and ordinarily resident in the UK unless stated otherwise.**

**Candidates should answer based on the legislative position immediately BEFORE the 2013 budget.**

## Instructions

- Two hours are allowed for this paper.
- **Do not begin writing until the invigilator instructs you to.**
- **Read the instructions on page 3 carefully before answering any questions.**
- Provide the information requested on the answer book and form B.
- You are allowed to write on the inside pages of this question paper, but you must **NOT** write your name, candidate number, PIN or any other identification anywhere on this question paper.
- The answer book and this question paper must **both be handed in personally by you** to the invigilator before you leave the examination room. **Failure to comply with this regulation will result in your paper not being marked and you may be prevented from entering this examination in the future.**

# Unit J05 – Pension income options

## Instructions to candidates

## Read the instructions below before answering any questions

- **Two hours** are allowed for this paper which consists of 15 short answer questions and carries a total of 130 marks.
- You are strongly advised to attempt **all** questions to gain maximum possible marks. The number of marks allocated to each question part is given next to the question and you should spend your time in accordance with that allocation.
- Read carefully all questions and information provided before starting to answer. Your answer will be marked strictly in accordance with the question set.
- You may find it helpful in some places to make rough notes in the answer booklet. If you do this, you should cross through these notes before you hand in the booklet.
- It is important to show all steps in a calculation, even if you have used a calculator.
- If you bring a calculator into the examination room, it must be a silent battery or solar-powered non-programmable calculator. The use of electronic equipment capable of being programmed to hold alphabetic or numerical data and/or formulae is prohibited. You may use a financial or scientific calculator, provided it meets these requirements.
- Tax tables are provided at the back of this question paper.
- Answer each question on a new page and leave six lines blank after each question part.

**Subject to providing sufficient detail you are advised to be as brief and concise as possible, using note format and short sentences on separate lines wherever possible.**

**Attempt ALL questions**

**Time: 2 hours**

*To gain maximum marks for calculations you **must** show **all** your workings and express your answers to **two** decimal places.*

**1.** **(a)** State the conditions that must be met in order for funds held in a personal pension arrangement to be paid out under the 'small pot' rules. **(4)**

**(b)** Explain how such a payment will be taxed. **(3)**

**2.** Nigel commenced drawdown in May 2003. The maximum permitted Government Actuary's Department (GAD) income at that time was £24,750 per annum. His latest review took place in May 2011 when the GAD maximum was recalculated as £17,850 per annum.

In December 2011, on his 65th birthday, Nigel crystallised benefits under a previous employer's defined benefit scheme. At that time he received a pension commencement lump sum of £15,800 plus an index linked pension of £2,370 per annum.

Nigel, who has never elected for any form of transitional protection, decides to crystallise further benefits held in a group personal pension plan (GPP), valued at £340,000, in March 2013. Calculate, **showing all your workings**, the percentage of Nigel's lifetime allowance that will remain after he has crystallised his GPP. **(10)**

**3.** Jenny, aged 42, is married to William, aged 44. They have two children aged 14 and 12.

Jenny has recently been diagnosed with a terminal illness and has been told she has a life expectancy of 18 months. Her only pension benefit is an uncrystallised personal pension plan (PPP) valued at £175,000.

**(a)** State the conditions that must be met for Jenny to be able to crystallise her PPP on the grounds of ill health. **(4)**

**(b)** Outline the ways in which the pension benefits can be paid to Jenny assuming she crystallises the PPP now. **(4)**

**(c)** Explain why Jenny may prefer to wait until her life expectancy is less than 12 months before she crystallises her PPP. **(2)**

**4.** Outline the factors that a member of a defined contribution occupational scheme should take into account when deciding whether to take their income via a scheme pension or a lifetime annuity. **(6)**

**5.** Henry, aged 73, is a higher-rate tax payer. His only sources of income are a capped drawdown arrangement, an investment bond and his State pensions.

Henry's income needs have reduced by £5,000 per annum and he is considering recycling the excess income into a personal pension plan. Explain the factors that Henry should consider when making his decision. **(9)**

**6.** Christopher crystallised a personal pension plan (PPP) valued at £1,440,000 in September 2011. At that time he took the maximum permitted pension commencement lump sum (PCLS).

In March 2013 Christopher reached his 75th birthday. His only other pension benefit is an uncrystallised PPP valued at £550,000. He has not registered for any form of transitional protection.

**(a)** Calculate, **showing all your workings**, the lifetime allowance tax charge payable in respect of Christopher's pension benefits when they were tested on his 75th birthday. **(6)**

**(b)** Calculate, **showing all your workings**, the maximum PCLS Christopher has remaining after the lifetime allowance charge, calculated in part **(a)** above, has been paid. **(4)**

**7.** State the **eight** circumstances in which a scheme pension may be reduced or stopped. **(8)**

**8.** Michael, aged 58 and single, has an uncrystallised personal pension valued at £710,000. He has a balanced attitude to investment risk and now wishes to take his benefits using phased income drawdown. He has no intention of purchasing an annuity before his 70th birthday. Recommend, giving your reasons, a suitable mix of asset classes for his pension fund. **(8)**

**9.** When considering the suitability of a capped drawdown arrangement, the critical yield and the impact of mortality drag are important factors to take into account.

**(a)** Outline what is meant by the term 'mortality drag'. **(3)**

**(b)** Explain why it is important that the critical yield A figure is recalculated regularly. **(7)**

**10.** Marjory, aged 65 and single, receives a total pension income of £120 per week for the tax year 2012/2013. She has savings of £18,200 in a deposit account and an endowment policy with a current value of £20,000. She has recently applied for State Pension Credit.

**(a)** Calculate, **explaining your method**, how much income per week her savings are deemed to provide for the purposes of the State Pension Credit. **(5)**

**(b)** Calculate, **showing all your workings**, the total income per week Marjory will receive if her application for State Pension Credit is successful. **(5)**

*The threshold for savings credit for tax year 2012/2013 is £111.80 per week.*

**11.** Philip, aged 67, who is a higher-rate tax payer, would like to draw an income of around £5,500 gross per annum from his pensions. In addition, he would like to take a lump sum payment of £10,000.

Philip's only pensions are an uncrystallised personal pension plan (PPP) valued at £300,000 and entitlement to the full Basic State Pension (BSP) which he deferred when he reached his State Pension age two years ago. He is unsure whether to take this income and lump sum from his deferred BSP or by drawing an income from his PPP.

Describe the factors that Phillip should take into account when making his decision. **(8)**

**Questions continue over the page**

**12.** Marcia, aged 65, designated funds into a drawdown arrangement on 12 February 2010. She is unhappy with the service she is receiving and now wishes to transfer the arrangement to another provider.

**(a)** List the conditions that must be satisfied for the transfer to be treated as an authorised transfer. **(4)**

**(b)** Explain how the new reference period and maximum permitted drawdown income will be calculated if she transfers her arrangement on 1 April 2013. **(5)**

**13.** From 21 December 2012, all new annuity contracts must be set up using unisex annuity rates.

**(a)** Outline why the difference in life expectancy between men and women is an important factor for annuity providers when setting unisex annuity rates. **(2)**

**(b)** Explain the effects that this change in legislation will have on the rates offered for impaired life annuities. **(4)**

**14.** George recently died, aged 58, leaving a widow Linda, aged 47, and two teenage children. George's pension benefits consist of a capped drawdown arrangement currently valued at £640,000 from which he was drawing a small annual income.

**(a)** Explain in detail how George's drawdown pension fund can be used to provide an income for Linda. **(7)**

**(b)** Outline the benefits payable to the children in the event of Linda's death, for each of the methods of producing income identified in part **(a)** above. **(6)**

**15.** Charles, aged 60, and Imogen, aged 58, are in the process of divorcing. In May 2012, as part of the financial settlement, Charles was awarded a pension credit of £250,000 against Imogen's drawdown pension fund of £1,300,000. Imogen set up her drawdown arrangement in September 2006.

**(a)** State why the pension credit will be tested against Charles' lifetime allowance. **(1)**

**(b)** Explain why, upon receipt of the pension credit, Charles will be able to claim an enhancement to his lifetime allowance. **(3)**

**(c)** Calculate, **showing all your workings**, the enhancement factor that will apply to Charles' lifetime allowance if the pension credit is transferred to his pension in April 2013. **(2)**

The tax tables can be found on pages 8 – 12

# INCOME TAX

| RATES OF TAX | 2011/2012 | 2012/2013 |
|---|---|---|
| Starting rate for savings* | 10% | 10% |
| Basic rate | 20% | 20% |
| Higher rate | 40% | 40% |
| Additional rate | 50% | 50% |
| Starting-rate limit | £2,560* | £2,710* |
| Threshold of taxable income above which higher rate applies | £35,000 | £34,370 |
| Threshold of taxable income above which additional rate applies | £150,000 | £150,000 |
| Child benefit charge from 7 January 2013: 1% of benefit for every £100 of income over | N/A | £50,000 |

**restricted to savings income only and not available if taxable non-savings income exceeds starting rate band.*

## MAIN PERSONAL ALLOWANCES AND RELIEFS

| | | |
|---|---|---|
| Income limit for Personal Allowance § | £100,000 | £100,000 |
| Personal Allowance (basic) § | £7,475 | £8,105 |
| Personal Allowance (age 65-74) § | £9,940 | £10,500 |
| Personal Allowance (aged 75 and over) § | £10,090 | £10,660 |
| Married/civil partners (minimum) at 10% † | £2,800 | £2,960 |
| Married/civil partners (age 75 and over) at 10% | £7,295 | £7,705 |
| Income limit for age-related allowances | £24,000 | £25,400 |
| Blind Person's Allowance | £1,980 | £2,100 |
| Enterprise Investment Scheme relief limit on £1,000,000 max (£500,000 in 2011/2012) | 30% | 30% |
| Seed Enterprise Investment relief limit on £100,000 | N/A | 50% |
| Venture Capital Trust relief limit on £200,000 max | 30% | 30% |

§ *the Personal Allowance reduces by £1 for every £2 of income above the income limit irrespective of age.*
† *where at least one spouse/civil partner was born before 6 April 1935.*

| | | |
|---|---|---|
| Child Tax Credit (CTC) | | |
| - Child element per child (maximum) | N/A | £2,690 |
| - family element | £545 | £545 |
| Threshold for tapered withdrawal of CTC | N/A | £15,860 |

# NATIONAL INSURANCE CONTRIBUTIONS

| Class 1 Employee | Weekly | Monthly | Yearly |
|---|---|---|---|
| Lower Earnings Limit (LEL) | £107 | £464 | £5,564 |
| Primary threshold | £146 | £634 | £7,605 |
| Upper Accrual Point | £770 | £3,337 | £40,040 |
| Upper Earnings Limit (UEL) | £817 | £3,540 | £42,475 |

| Total earnings £ per week | CLASS 1 EMPLOYEE CONTRIBUTIONS | |
|---|---|---|
| | **Contracted-in rate/contracted-out (money purchase)** | **Contracted-out rate (final salary)** |
| Up to 146.00* | Nil | Nil |
| 146.01 – 770.00 | 12% | 10.6% |
| 770.01 – 817.00 | 12% | 12% |
| Above 817.00 | 2% | 2% |

**This is the primary threshold below which no NI contributions are payable. However, the lower earnings limit is £107 per week. This £107 to £146 band is a zero rate band introduced in order to protect lower earners' rights to contributory State benefits e.g. Basic State Pension.*

| Total earnings £ per week | CLASS 1 EMPLOYER CONTRIBUTIONS | | |
|---|---|---|---|
| | **Contracted-in rate** | **Contracted-out rate** | |
| | | *Final salary* | *Money purchase* |
| Below 144.00** | Nil | Nil | Nil |
| 144.01 – 770.00 | 13.8% | 10.4% | 13.8% |
| 770.01 – 817.00 | 13.8% | 13.8% | 13.8% |
| Excess over 817.00 | 13.8% | 13.8% | 13.8% |

*** Secondary earnings threshold.*

| | |
|---|---|
| **Class 2 (self-employed)** | Flat rate per week £2.65 where earnings exceed £5,595 per annum. |
| **Class 3 (voluntary)** | Flat rate per week £13.25. |
| **Class 4 (self-employed)** | 9% on profits between £7,605 - £42,475<br>2% on profits above £42,475. |

# PENSIONS

| 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 |
| 2011/2012 | £1,800,000 | £50,000 |
| 2012/2013 | £1,500,000 | £50,000 |

**ANNUAL ALLOWANCE CHARGE**

20% - 50% member's tax charge on the amount of total pension input in excess of the annual allowance.

**LIFETIME ALLOWANCE CHARGE**

55% of excess over lifetime allowance if taken as a lump sum.

25% of excess over lifetime allowance if taken in the form of income, which is subsequently taxed under PAYE.

# INHERITANCE TAX

| RATES OF TAX ON DEATH TRANSFERS | 2011/2012 | 2012/2013 |
|---|---|---|
| Transfers made after 5 April 2012 | | |
| - Up to £325,000 | Nil | Nil |
| - Excess over £325,000 | 40% | 40% |
| - Lifetime transfers to and from certain trusts | 20% | 20% |

**For deaths after 5 April 2012, a lower rate of 36% applies where at least 10% of deceased's net estate is left to charity.*

| MAIN EXEMPTIONS | | |
|---|---|---|
| Transfers to | | |
| - UK-domiciled spouse/civil partner | No limit | No limit |
| - non-UK-domiciled spouse/civil partner (from UK-domiciled spouse) | £55,000 | £55,000 |
| - UK-registered charities | No limit | No limit |
| Lifetime transfers | | |
| - Annual exemption per donor | £3,000 | £3,000 |
| - Small gifts exemption | £250 | £250 |
| Wedding/civil partnership gifts by | | |
| - parent | £5,000 | £5,000 |
| - grandparent | £2,500 | £2,500 |
| - other person | £1,000 | £1,000 |

100% relief: businesses, unlisted/AIM companies, certain farmland/building
50% relief: certain other business assets

Reduced tax charge on gifts within 7 years of death:

| | | | | | |
|---|---|---|---|---|---|
| - Years before death | 0-3 | 3-4 | 4-5 | 5-6 | 6-7 |
| - Inheritance Tax payable | 100% | 80% | 60% | 40% | 20% |

# CAR BENEFIT FOR EMPLOYEES

The charge for company car benefits is based on the carbon dioxide (CO2) emissions. There is no reduction for high business mileage users.

**For 2012/2013:**

- Cars that cannot emit $CO_2$ have a 0% charge.
- The percentage charge is 5% of the car's list price for CO2 emissions of 75g/km or less.
- For cars with $CO_2$ emissions of 76g/km to 99g/km the percentage is 10%.
- Cars with $CO_2$ emissions of 100g/km have a percentage charge of 11% and thereafter the charge increases by 1% for every complete 5g/km to a maximum of 35% (emissions of 220g/km and above).

There is an additional 3% supplement for diesel cars not meeting Euro IV emission standards. However, the maximum charge remains 35% of the car's list price.

**Car fuel** The benefit is calculated as the $CO_2$ emissions % relevant to the car and that % applied to a set figure (£20,200 for 2012/2013) e.g. car emission 100g/km = 11% on car benefit scale. 11% of £20,200 = £2,222.

1. **Accessories** are, in most cases, included in the list price on which the benefit is calculated.
2. **List price** is reduced for capital contributions made by the employee up to £5,000.
3. **Car benefit** is reduced by the amount of employee's contributions towards running costs.
4. **Fuel scale** is reduced only if the employee makes good **all** the fuel used for private journeys.
5. **All car and fuel benefits** are subject to employers National Insurance Contributions (Class 1A) of 13.8%.

## PRIVATE VEHICLES USED FOR WORK

| | 2011/2012 Rates | 2012/2013 Rates |
|---|---|---|
| **Cars** | | |
| On the first 10,000 business miles in tax year | 45p per mile | 45p per mile |
| Each business mile above 10,000 business miles | 25p per mile | 25p per mile |
| **Motor Cycles** | 24p per mile | 24p per mile |
| **Bicycles** | 20p per mile | 20p per mile |

## MAIN CAPITAL AND OTHER ALLOWANCES

| | 2011/2012 | 2012/2013 |
|---|---|---|
| Plant & machinery (excluding cars) 100% annual investment allowance (first year) | £100,000 | £25,000 |
| Plant & machinery (reducing balance) per annum | 20% | 18% |
| Patent rights & know-how (reducing balance) per annum | 25% | 25% |
| Certain long-life assets, integral features of buildings (reducing balance) per annum | 10% | 8% |
| Energy & water-efficient equipment | 100% | 100% |
| Zero emission goods vehicles (new) | 100% | 100% |
| Qualifying flat conversions, business premises & renovations | 100% | 100% |

**Motor cars:** Expenditure on or after 01/04/09 (Corporation Tax) or 06/04/09 (Income Tax)

| | | | |
|---|---|---|---|
| $CO_2$ emissions of g/km: | 110 or less* | 111-160 | 161 or more |
| Capital allowance: | 100% first year | 18% reducing balance | 8% reducing balance |

*If new

| | | |
|---|---|---|
| Research & Development: | Capital expenditure | 100% |

## MAIN SOCIAL SECURITY BENEFITS

| | | 2011/2012 | 2012/2013 |
|---|---|---|---|
| | | £ | £ |
| Child Benefit | First child | 20.30 | 20.30 |
| | Subsequent children | 13.40 | 13.40 |
| | Guardian's allowance | | 15.55 |
| Employment and Support Allowance | Assessment Phase | | |
| | Age 16 – 24 | Up to 53.45 | Up to 56.25 |
| | Aged 25 or over | Up to 67.50 | Up to 71.00 |
| | Main Phase | | |
| | Work Related Activity Group | Up to 94.25 | Up to 99.15 |
| | Support Group | Up to 99.85 | Up to 105.05 |
| Attendance Allowance | Lower rate | 49.30 | 51.85 |
| | Higher rate | 73.60 | 77.45 |
| Retirement Pension | Single | 102.15 | 107.45 |
| | Married | 163.35 | 171.85 |
| Pension Credit | Single person standard minimum guarantee | 137.35 | 142.70 |
| | Married couple standard minimum guarantee | 209.70 | 217.90 |
| | Maximum savings ignored in calculating income | 10,000.00 | 10,000.00 |
| Bereavement Payment (lump sum) | | 2,000.00 | 2,000.00 |
| Widowed Parent's allowance | | 100.70 | 105.95 |
| Jobseekers Allowance | Age 16 - 24 | 53.45 | 56.25 |
| | Age 25 or over | 67.50 | 71.00 |
| Statutory Maternity, Paternity and Adoption Pay | | 128.73 | 135.45 |

# CAPITAL GAINS TAX

| EXEMPTIONS | 2011/2012 | 2012/2013 |
|---|---|---|
| Individuals, estates etc | £10,600 | £10,600 |
| Trusts generally | £5,300 | £5,300 |
| Chattels proceeds (restricted to five thirds of proceeds exceeding limit) | £6,000 | £6,000 |

| TAX RATES | | |
|---|---|---|
| Individuals: | | |
| Up to basic rate limit | 18% | 18% |
| Above basic rate limit | 28% | 28% |
| Trustees and Personal Representatives | 28% | 28% |
| Entrepreneurs' Relief* – Gains taxed at: | 10% | 10% |
| Lifetime limit | £10,000,000 | £10,000,000 |

*For trading businesses and companies (minimum 5% employee or director shareholding) held for at least one year.

# CORPORATION TAX

| | 2011/2012 | 2012/2013 |
|---|---|---|
| Full rate | 26% | 24% |
| Small companies rate | 20% | 20% |
| Small companies limit | £300,000 | £300,000 |
| Effective marginal rate | 27.5% | 25.0% |
| Upper marginal limit | £1,500,000 | £1,500,000 |

# VALUE ADDED TAX

| | 2011/2012 | 2012/2013 |
|---|---|---|
| Standard rate | 20% | 20% |
| Annual Registration limit | £73,000 | £77,000 |

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