THE CHARTERED INSURANCE INSTITUTE

AF3

Advanced Diploma in Financial Planning

Unit AF3 – Pension planning

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

- Three 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.**

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Unit AF3 – Pension planning

Instructions to candidates

Read the instructions below before answering any questions

- **Three hours** are allowed for this paper which carries a total of 160 marks as follows:
- Section A: 80 marks
  Section B: 80 marks
- You are advised to spend approximately 90 minutes on Section A and 90 minutes on Section B.
- 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.

SECTION A

This question is compulsory and carries 80 marks

Question 1

Duncan, aged 60, is married and works as a senior investment manager with a national firm of stockbrokers. Both he and his wife Celia, aged 62, are in poor health and as a result Duncan's employer has agreed to him reducing his working hours.

In addition to his earnings, Duncan receives an annual income of £22,500 from a former employer's defined benefit scheme which came into payment on 1 December 2012. This benefit used up 30% of the standard lifetime allowance.

Duncan intends to replace his lost income by utilising his self-invested personal pension (SIPP), currently valued at £2,095,000. He has been quoted an enhanced lifetime annuity rate of 6.2%, based on a single life, level annuity with no guarantee, payable annually in advance. As an alternative, his drawdown Government Actuary Department (GAD) rate is 4.8% with type A critical yields of 4.9% to age 70 and 5% to age 75, based on standard annuity rates.

Duncan has registered for primary protection with a lifetime allowance enhancement factor of 0.25. He does not, however, have any tax-free cash protection.

Celia recently requested details of her deferred benefit within the Wiseboy Ltd defined benefit pension scheme. Celia was a member of the scheme for a short period of time in the 1980s. The details of her entitlement under the scheme is detailed below:

Date of joining scheme	1 February 1981
Date of leaving scheme	17 March 1986
Pension as at date of leaving	£1,875 per annum, including guaranteed minimum pension (GMP) of £470 per annum
Estimated pension at normal retirement age (65)	£3,585 per annum, including GMP of £2,030 per annum
GMP revaluation	Limited revaluation
Excess above GMP	Statutory minimum revaluation
Cash equivalent transfer value (CETV) as at March 2013	£39,450

Celia is surprised that the estimated pension at age 65 is so low, given the length of time between leaving service and age 65.

Questions

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

(a) **(i)** Calculate, **showing all of your workings**, the lifetime allowance charge payable by Duncan assuming he fully crystallises his self-invested personal pension and takes any excess benefits above his personal lifetime allowance as a lump sum. **(8)**

(ii) Explain, using calculations to support your answer, why the maximum pension commencement lump sum available to Duncan is £262,500. **(5)**

(b) Duncan is unsure how to replace his shortfall in income and is considering phased annuity purchase, phased capped drawdown or phased flexible drawdown.

(i) Calculate, **showing all of your workings**, the **minimum** amount of Duncan's self-invested personal pension that needs to be crystallised under each of these options, to provide him with a net payment of £18,760 for the tax year 2013/2014. *Assume Duncan is a 40% taxpayer in your calculations.* **(8)**

(ii) Taking account of Duncan's specific circumstances, state **four** benefits and **four** drawbacks to Duncan of utilising phased flexible drawdown rather than phased annuity purchase to replace his shortfall in income. **(8)**

(iii) Explain briefly the options available to Celia in respect of any uncrystallised funds, including the relevant tax treatment, should Duncan die prior to age 75, whilst utilising phased flexible drawdown to replace his lost income. **(4)**

(c) In respect of the drawdown illustration recently received by Duncan:

(i) explain in detail how the Government Actuary Department rate of 4.8% has been established; **(7)**

(ii) explain why the type A critical yields as quoted are not relevant to his personal circumstances. **(4)**

Questions continue over the page

(d) In respect of Wiseboy Ltd:

(i) Celia does not believe her benefits have been calculated correctly. Explain in detail the process that Celia should follow and how it would be dealt with if she wishes to make a complaint. *You should include the roles, responsibilities and powers of the Scheme Trustees, The Pensions Advisory Service and The Pensions Ombudsman in your answer.* **(9)**

(ii) Explain in detail how Celia's benefits will be revalued before retirement and how they will escalate once in payment, including the role of the State in meeting any increases due. **(9)**

(iii) Describe the process that will have been followed in calculating Celia's cash equivalent transfer value (CETV). **(8)**

(iv) State, giving your reasons, the factors that might influence Celia to take her CETV. **(7)**

(v) Calculate, **showing all of your workings**, the maximum amount of pension commencement lump sum that could be paid to Celia under post A-day rules based on the estimated pension at age 65 of £3,585. *Use a commutation factor of 12 in your calculations.* **(3)**

Total marks available for this question: 80

Section B questions can be found on pages 8 – 11

SECTION B

Both questions in this section are compulsory and carry an overall total of 80 marks

Question 2

Adrian, aged 58, is married to Clare, aged 60. They are both planning to retire when Adrian reaches his State Pension age and are looking to increase their pension contributions.

Adrian has been a member of his employer's defined contribution occupational pension scheme (DC OPS) since January 2001. The scheme operates on a 5% matching contribution basis.

In addition to his employer's scheme, Adrian makes ad-hoc lump sum contributions to a self-invested personal pension (SIPP), currently valued at £280,000. Both schemes have a pension input period in line with the tax year. Adrian's pensionable earnings and contributions are detailed below.

Tax Year	Pensionable Earnings (£)	Contributions to the DC OPS (Gross) (£)	Contributions to the SIPP (Gross) (£)
2013/2014	138,000 (estimate)	13,800	NIL
2012/2013	126,000	12,600	23,750
2011/2012	122,000	12,200	40,000
2010/2011	102,000	10,200	35,000

Clare has annual earnings of £51,000 and is a member of her employer's group stakeholder pension scheme to which her employer contributes 3% of her salary. Clare has not made any personal contributions to the scheme and does not have any other provision over and above that provided by the State. Contributions to the scheme are currently being invested in the default lifestyle investment strategy with a selected retirement age of 65.

Clare is due to receive a gross bonus of £12,000 and is considering using this to boost her retirement savings. Her employer is prepared to offer bonus sacrifice and enhance the pension contribution by 50% of its National Insurance saving.

Questions

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

(a) Calculate, **showing all your workings**, the maximum additional net contribution that Adrian could make to his self-invested pension plan (SIPP) in the tax year 2013/2014, without changing his pension input periods or incurring an annual allowance charge. **(6)**

(b) Adrian is considering drawing his pension benefits via a lifetime annuity when he reaches State Pension age but is concerned that annuity rates have fallen over recent years. He is aware that falling gilt yields and improved longevity have been contributing factors.

(i) Explain why the Bank of England's recent quantitative easing led to a reduction in gilt yields. **(3)**

(ii) Outline the impact that the growth of the impaired life annuity market over recent years has had on standard annuity rates. **(3)**

(c) Clare is planning to utilise the bonus she will receive to boost her pension funding.

(i) Calculate, **showing all your workings**, the amount of pension contribution that would be invested if Clare paid the net bonus into the stakeholder pension scheme. **(4)**

(ii) Calculate, **showing all your workings**, the amount of higher-rate tax relief Clare would receive having made the personal contribution in part **(c)(i)** above. **(2)**

(iii) State how Clare can obtain this higher-rate tax relief. **(2)**

(iv) Calculate, **showing all your workings**, how much would be contributed to Clare's stakeholder pension scheme if she sacrificed the entire bonus in exchange for an employers' pension contribution. **(3)**

(v) State, giving reasons, whether it would be better for Clare to make the pension contribution via relief at source or bonus sacrifice. **(4)**

(d) Assuming Clare decides to defer her State Pension, outline the qualifying conditions, calculation methods and the relevant tax treatment of any benefits Clare might receive following a period of deferral. *No calculations are required.* **(6)**

(e) In respect of Clare's stakeholder pension scheme:

(i) describe briefly the features of a lifestyle investment strategy; **(4)**

(ii) explain briefly the potential implications of Clare's stated intention to retire when Adrian reaches his State Pension age on her stakeholder pension investment strategy. **(3)**

Total marks available for this question: 40

Questions continue over the page

Question 3

Susan, aged 52, recently received correspondence from the trustees of her former employer, Dunnikier Industries Ltd, defined benefit pension scheme outlining the current financial position of the scheme.

The Dunnikier Industries Ltd defined benefit pension scheme was established for senior executives of the firm and provided very generous benefits. However, it would now appear that the company are in financial difficulty and have opened up negotiations with the trustees on possible options for reducing the scheme deficit.

The funding position of the scheme as at 1 October 2011, is deleted below.

Valuation Type	**Funding Position**
Buy-Out	46%
Ongoing	78%
Pension Protection Fund (Section 179)	108%

Since leaving Dunnikier Industries Ltd in 1992, Susan became a director of her husband Peter's highly successful marketing company, PDM Ltd. The business has continued to grow significantly and now employs 85 staff. As a result, Peter is considering the purchase of additional premises.

Peter and Susan currently have a small self-administered pension scheme with pooled assets of £1,875,000, fully invested in insured funds. Peter, aged 46, plans to retire as managing director of the business in approximately 10 years time.

Questions

(a) State the possible actions that could be undertaken by Dunnikier Industries Ltd and the scheme trustees to reduce the deficit on the defined benefit pension scheme. **(8)**

(b) Outline briefly the purpose of each of the following:

(i) buy-out (insolvency) valuation; **(4)**

(ii) ongoing valuation; **(4)**

(iii) Pension Protection Fund (Section 179) valuation. **(4)**

(c) In the event of Dunnikier Industries Ltd becoming insolvent, list the priority order for the distribution of scheme assets upon wind-up due to employer insolvency. **(8)**

(d) Peter and Susan want to explore the possibility of the small self-administered pension scheme making a loan to PDM Ltd, to help fund the purchase of additional premises.

Explain briefly, the key tests that are undertaken by HM Revenue & Customs in ascertaining whether such a loan to PDM Ltd meets the authorised payment requirements, in respect of each of the following areas:

(i) security; **(2)**

(ii) interest rate; **(4)**

(iii) term; **(2)**

(iv) value of loan; **(2)**

(v) repayment. **(2)**

Total marks available for this question: 40

The tax tables can be found on pages 13 – 17

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 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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