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THE CHARTERED INSURANCE INSTITUTE

J05

Diploma in Financial Planning

Unit J05 – Pension income options

April 2014 examination

SPECIAL NOTICES

All questions in this paper are based on English law and practice applicable in the tax year 2013/2014, unless stated otherwise in the question, and should be answered accordingly.

It should be assumed that all individuals are domiciled and resident in the UK unless otherwise stated.

Candidates should answer based on the legislative position immediately BEFORE the 2014 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.**

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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.

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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. In respect of a lifetime annuity:

(a) Outline HM Revenue & Customs definition of a dependant. **(6)**

(b) List **five** restrictions that apply to a dependant's lifetime annuity once in payment that do not apply to a member's lifetime annuity. **(5)**

2. On 5 April 2006, Dougal had total pension rights of £1,600,000 and a tax-free cash entitlement of £450,000. He has both primary and enhanced protection.

Dougal now wants to draw his benefits. His pension rights are currently valued at £1,900,000.

Calculate, **showing all your workings**, Dougal's entitlement to a pension commencement lump sum under each of primary protection and enhanced protection assuming he crystallised his benefits in March 2014. **(7)**

3. George, aged 57, is a member of his company's defined benefit pension scheme, which has a defined contribution section. He is taking redundancy and has been offered a redundancy payment of £48,000. He is entitled to an immediate unreduced pension of £12,000 per annum, part of which can be commuted to provide a pension commencement lump sum if required.

His employer has offered to pay £18,000 of his redundancy lump sum directly into the defined contribution section of the scheme.

Explain, in detail, the **benefits** of this course of action for George. *No calculation is required.* **(6)**

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4. Phillip has recently retired and is entitled to a full Basic State Pension (BSP). He has decided to retire abroad and will be non-UK resident for tax purposes.

In respect of Phillip's BSP:

(a) Outline whether his entitlement, including his yearly indexation increases, will be affected by the country to which he decides to retire. **(5)**

(b) State how his pension will be taxed if he retires abroad. **(2)**

5. The Financial Conduct Authority's Conduct of Business Sourcebook provides guidance to advisers when they are recommending a drawdown pension via income withdrawals or by using a 'short-term annuity'.

Describe the key risk factors involved in entering into a drawdown pension that must be explained to the client in the suitability letter. **(5)**

6. Olivia wants to crystallise all of her pension benefits. She will receive a scheme pension from her defined benefit scheme of £50,000 per annum plus a pension commencement lump sum (PCLS) of £150,000.

She also has a personal pension plan (PPP), which has a current fund value of £520,000. She plans to take the maximum PCLS and use the balance of the fund to secure an income. The income can either be provided by a lifetime annuity or by a scheme pension. The most competitive annuity rate that is currently available for the scheme pension is 2.80%.

Calculate, **showing all your workings**, the total amount that will be assessed against the lifetime allowance if Olivia crystallises the PPP in March 2014 and secures:

(a) a lifetime annuity; **(5)**

(b) a scheme pension. **(7)**

7. Outline the circumstances when a capped drawdown pension will be reviewed, other than at the start of a new reference period. **(5)**

Questions continue over the page

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8. Catherine, aged 60, is retired and married to David, aged 68. They are both in receipt of scheme pensions from their defined benefit pension schemes and are higher-rate taxpayers.

Catherine has an uncrystallised pension fund worth £650,000 and wishes to take withdrawals from this on an annual basis until her State Pension comes into payment. Catherine and David have substantial cash assets and do not need any additional capital sums at this time. Catherine has a medium to high risk profile and wants to ensure that the maximum lump sum is available to David and her adult children following her death.

Explain, in detail, the potential **benefits** for Catherine of using phased drawdown to provide additional income in retirement. **(10)**

9. In July 2011, Sarah used £200,000 of her personal pension fund to purchase a lifetime annuity of £10,500 per annum, payable annually in advance. She chose to include annuity protection. She transferred the remainder of her pension fund into capped drawdown.

Sarah, who was married to Henry, died in March 2014 with £120,000 in her drawdown pension fund.

(a) Explain briefly how the lump sum payment due under annuity protection would be calculated, including the tax treatment. **(4)**

(b) Outline the potential death benefits available to Henry from Sarah's drawdown pension fund, including their tax treatment. **(8)**

10. The critical yield calculation is used to show the investment returns required from a drawdown pension arrangement.

(a) Outline the regulatory guidelines regarding the use of critical yields A and B in drawdown pension illustrations. **(6)**

(b) Explain briefly why quoting critical yield A, based on standard annuity rates, would not be relevant for an individual who was eligible for an impaired life annuity. **(3)**

11. Bob has recently died. Outline how his wife's entitlement to his State Earnings Related Pension will be calculated. **(5)**

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12. Karin, aged 59, is a retired pharmacist undertaking part-time work as a locum earning £15,000 per annum. She has an uncrystallised personal pension plan (PPP) valued at £750,000, which is her only pension arrangement.

Karin, who is a basic-rate tax payer, would like to generate a net payment of £7,000 for the tax year 2013/2014 from her PPP by capped drawdown pension. The relevant factor based on the Government Actuary's Department table for her age is 5.5%.

(a) Calculate, **showing all your workings**, the minimum amount of Karin's PPP that needs to be crystallised to provide the required level of withdrawal for the tax year 2013/2014. **(7)**

(b) Calculate, **showing all your workings**, the net lump sum death benefit that could be available from Karin's pension immediately after the crystallisation in part **(a)** above. **(5)**

(c) Explain how a spousal bypass trust may benefit Karin's husband and children following her death. **(3)**

13. Gordon, aged 64, is currently utilising the capped drawdown pension option. He has no plans to purchase an annuity and his fund is invested wholly in fixed interest funds and cash.

(a) Explain briefly why Gordon's current investment funds may not be suitable. **(3)**

(b) Describe briefly why the following asset classes could be appropriate for Gordon:

(i) Equities. **(3)**

(ii) Property. **(3)**

(c) Explain why retaining an element of fixed interest funds and cash may be suitable for Gordon. **(4)**

Questions continue over the page

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14. In recent years, defined benefit schemes have had to consider ways of reducing the risk and liabilities in their schemes. One solution is for schemes to offer pension increase exchange, whereby members have the option of exchanging non-statutory pension escalation for a higher non-increasing pension.

Outline the **five** key principles that The Pensions Regulator states an employer must consider when offering pension increase exchange to its members. **(5)**

15. Rose, aged 72, is married to Brian, aged 74. She is currently drawing an income from her capped drawdown pension fund and is considering purchasing a lifetime annuity.

State **four** benefits and **four** drawbacks of Rose purchasing an annuity. **(8)**

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The tax tables can be found on pages 10 – 16

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INCOME TAX

RATES OF TAX	2012/2013	2013/20
Starting rate for savings*	10%	10%
Basic rate	20%	20%
Higher rate	40%	40%
Additional rate	50%	45%
Starting-rate limit	£2,710*	£2,790*
Threshold of taxable income above which higher rate applies	£34,370	£32,010
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	£50,000	£50,000

Note: **2013/20* is partly hidden by the banner; read it as **2013/2014**. I didn't fill in the hidden characters.

**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 if born after 5 April 1948) §	£8,105	£9,440
Personal Allowance (if born between 6 April 1938 and 5 April 1948) §	£10,500	£10,500
Personal Allowance (if born before 6 April 1938) §	£10,660	£10,660
Married/civil partners (minimum) (if born before 6 April 1935) at 10% †	£2,960	£3,040
Married/civil partners (if born before 6 April 1935) at 10% †	£7,705	£7,915
Income limit for age-related allowances	£25,400	£26,100
Blind Person's Allowance	£2,100	£2,160
Enterprise Investment Scheme relief limit on £1,000,000 max	30%	30%
Seed Enterprise Investment relief limit on £100,000	50%	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 (under the income threshold).
† where at least one spouse/civil partner was born before 6 April 1935.

Child Tax Credit (CTC)		
- Child element per child (maximum)	£2,690	£2,720
- family element	£545	£545
Threshold for tapered withdrawal of CTC	£15,860	£15,910

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NATIONAL INSURANCE CONTRIBUTIONS

Class 1 Employee	Weekly	Monthly	Yearly
Lower Earnings Limit (LEL)	£109	£473	£5,668
Primary threshold	£149	£646	£7,755
Upper Accrual Point	£770	£3,337	£40,040
Upper Earnings Limit (UEL)	£797	£3,454	£41,450

Total earnings £ per week	CLASS 1 EMPLOYEE CONTRIBUTIONS	
	Contracted-in rate/contracted-out (money purchase)	Contracted-out rate (final salary)
Up to 149.00*	Nil	Nil
149.01 – 770.00	12%	10.6%
770.01 – 797.00	12%	12%
Above 797.00	2%	2%

**This is the primary threshold below which no NI contributions are payable. However, the lower earnings limit is £109 per week. This £109 to £149 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 148.00**	Nil	Nil	Nil
148.01 – 770.00	13.8%	10.4%	13.8%
770.01 – 797.00	13.8%	13.8%	13.8%
Excess over 797.00	13.8%	13.8%	13.8%

*** Secondary earnings threshold.*

Class 2 (self-employed)	Flat rate per week £2.70 where earnings exceed £5,725 per annum.
Class 3 (voluntary)	Flat rate per week £13.55.
Class 4 (self-employed)	9% on profits between £7,755 - £41,450 2% on profits above £41,450.

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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
2013/2014	£1,500,000	£50,000

ANNUAL ALLOWANCE CHARGE
20% - 45% 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.

CAPITAL GAINS TAX

EXEMPTIONS	2012/2013	2013/2014
Individuals, estates etc	£10,600	£10,900
Trusts generally	£5,300	£5,450
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.*

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INHERITANCE TAX

RATES OF TAX ON DEATH TRANSFERS	2012/2013	2013/20
Transfers made after 5 April 2013		
- 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 2013, 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	£325,000
- 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%

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CAR BENEFIT FOR EMPLOYEES

The charge for company car benefits is based on the carbon dioxide (CO_2) emissions. There is no reduction for high business mileage users.

For 2013/2014:

- Cars that cannot emit CO_2 have a 0% charge.
- The percentage charge is 5% of the car's list price for CO_2 emissions of 75g/km or less.
- For cars with CO_2 emissions of 76g/km to 94g/km the percentage is 10%.
- For cars with CO_2 emissions of 95g/km to 99g/km the percentage is 11%.
- Cars with CO_2 emissions of 100g/km have a percentage charge of 12% and thereafter the charge increases by 1% for every complete 5g/km to a maximum of 35% (emissions of 215g/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 (£21,100 for 2013/2014) e.g. car emission 100g/km = 12% on car benefit scale. 12% of £21,100 = £2,532.

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

	2012/2013 Rates	2013/2014 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

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MAIN CAPITAL AND OTHER ALLOWANCES

	2012/2013	2013/2014
Plant & machinery (excluding cars) 100% annual investment allowance (first year)	£25,000	£250,000
Plant & machinery (reducing balance) per annum	18%	18%
Patent rights & know-how (reducing balance) per annum	25%	25%
Certain long-life assets, integral features of buildings (reducing balance) per annum	8%	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 April 2013 (Corporation Tax) or 06 April 2013 (Income Tax)

CO_2 emissions of g/km:	95 or less*	96-130	131 or more
Capital allowance:	100% first year	18% reducing balance	8% reducing balance

*If new

Research & Development:	Capital expenditure	100%

CORPORATION TAX

	2012/2013	2013/2014
Full rate	24%	23%
Small companies rate	20%	20%
Small companies limit	£300,000	£300,000
Effective marginal rate	25%	23.75%
Upper marginal limit	£1,500,000	£1,500,000

VALUE ADDED TAX

	2012/2013	2013/2014
Standard rate	20%	20%
Annual registration threshold	£77,000	£79,000
Deregistration threshold	£75,000	£77,000

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MAIN SOCIAL SECURITY BENEFITS

		2012/2013	2013/2
		£	£
Child Benefit	First child	20.30	20.30
	Subsequent children	13.40	13.40
	Guardian's allowance	15.55	15.90
Employment and Support Allowance	Assessment Phase		
	Age 16 – 24	Up to 56.25	Up to 56.80
	Aged 25 or over	Up to 71.00	Up to 71.70
	Main Phase		
	Work Related Activity Group	Up to 99.15	Up to 100.15
	Support Group	Up to 105.05	Up to 106.50
Attendance Allowance	Lower rate	51.85	53.00
	Higher rate	77.45	79.15
Retirement Pension	Single	107.45	110.15
	Married	171.85	176.15
Pension Credit	Single person standard minimum guarantee	142.70	145.40
	Married couple standard minimum guarantee	217.90	222.05
	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		105.95	108.30
Jobseekers Allowance	Age 16 - 24	56.25	56.80
	Age 25 or over	71.00	71.70
Statutory Maternity, Paternity and Adoption Pay		135.45	136.78

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