# Pension tax changes - what's the plan?

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Pensions Briefing

## HIGHLIGHTS

HM Treasury has confirmed some aspects of its proposals to restrict the level of tax relief available to members of registered pension schemes. Key points are:

- The annual allowance will be reduced to £50,000 from 6 April 2011, for defined benefit and defined contribution schemes.
- Where an individual exceeds the new annual allowance, any unused annual allowance in the previous three tax years (assumed to be £50,000 for 2008/09, 2009/10 and 2010/11) may be used to offset the additional pension saving.
- Accrual in a defined benefit scheme will be valued using a flat rate factor of 16.
- Death benefits and total commutation in cases of serious ill health will be exempt from the annual allowance.
- The Government is looking to exempt some ill health benefits from the annual allowance.
- Enhanced benefits on redundancy will not be exempt from the annual allowance.
- The lifetime allowance will reduce to £1.5m in 2012/13.
- Steps are planned to ensure that benefit structures such as employer-financed retirement benefit schemes (EFRBS) are no more attractive than other forms of remuneration.

## BACKGROUND

The previous Labour Government determined to raise £4bn of tax revenue by limiting the tax relief on pension contributions available to individuals earning £150,000 or more per year, through the introduction of the "high income excess relief charge". The restrictions were due to have effect from 6 April 2011, with transitional measures ("anti-forestalling") put in place in the meantime to prevent high earners from increasing pension contributions before 6 April 2011 to take advantage of the more generous tax relief before it disappeared.

The Coalition Government has confirmed the policy of reducing the cost of pension tax relief to the Treasury - but in the June 2010 Budget announced that it was seeking an alternative approach to achieve this. A discussion paper issued by the Treasury and HMRC in July proposed reducing the annual allowance significantly for all members instead, regardless of income.

### Reminder - annual allowance

The annual allowance (currently £255,000) is an important feature of the current pension tax regime, introduced on 6 April 2006 ("A-Day"). Through the annual allowance, HMRC has sought to limit the amount of tax-privileged pension saving an individual can build up in a year by subjecting any increase in pension saving in excess of the annual allowance to the annual allowance tax charge.

Broadly, the value of an individual's pension saving in a year (his or her "total pension input amount") is assessed as the sum of any money purchase contributions paid by the individual or his employer, plus the deemed value of any DB accrual. The time period used (the "pension input period" or "PIP) is usually 12 months and may or may not coincide with the tax year.

## REDUCING THE ANNUAL ALLOWANCE

As expected, the annual allowance is being significantly reduced from its current level of £255,000 to £50,000 - more than the £30,000 to £45,000 indicated in the July paper.

The reduction in the annual allowance will have effect from the 2011/12 tax year and will apply to both defined benefit (DB) and defined contribution (DC) schemes. It is not intended to increase the annual allowance in line with inflation before the end of the forecast period to 2015/16.

Individuals who exceed the annual allowance will face a tailored annual allowance charge - designed to recover the marginal rate tax relief that the individual has benefitted from.

### Carry forward of unused annual allowance

An individual whose pension accrual exceeds the annual allowance will be able to carry forward any unused annual allowance from the previous three tax years and offset this against the excess accrual. For this purpose, the annual allowance for each of the tax years 2008/09, 2009/10 and 2010/11 will be taken to be £50,000.

This concession will be good news for individuals who may experience significant one-off increases in their pension value, for example long-serving members of a DB scheme who are promoted with a substantial salary raise. The self-employed and partners in professional firms, whose income fluctuates from year to year, will also welcome the increased flexibility to pay higher contributions in a particularly profitable year without being penalised through the annual allowance charge.

### Tax relief on pension contributions

Individuals will be given tax relief on their pension contributions at their marginal tax rate. The high income excess relief charge provisions (which would have restricted pension tax relief for very high earners to 20%) will be repealed.

### Valuing accrual in defined benefit (DB) schemes

At present, when assessing whether the increase in value of an individual's pension benefits in a particular year exceeds the annual allowance, accrual in a DB scheme is valued using a factor of 10. For example, if an individual's accrued pension at the end of the year is £1,000 greater than at the start of the year, this increase is given a value of £10,000 (10 x £1,000).

The Government Actuary's Department has recommended the factor is increased and, from 6 April 2011, DB accrual will be valued using a flat rate factor of 16. The higher factor will increase the deemed value of DB accrual - an increase in benefit of £1,000 will now be considered worth £16,000. An increase in value of a pension of over £3,125 per year (ignoring an allowance for revaluation) will now exceed the annual allowance.

For active members, the amount of DB benefits accrued at the start of a relevant tax year will be revalued before the increase in value of the benefits during the year is assessed. Any negative accruals will be treated as zero.

### Deferred members

Deferred benefits will be exempt from the annual allowance regime, where there is no increase in value attributable to ongoing service and salary and the revaluation of accrued rights is within reasonable limits. Benefits that retain a final salary link would not be exempt.

### Pension input periods (PIPs)

PIPs that do not coincide with the tax year will continue to be allowed. Where an individual has already started a PIP that includes some time in the 2011/12 tax year, transitional rules will apply.

## SPECIAL CASES

At present, the annual allowance test does not apply in the year in which a member's benefits come into payment. The Government has recognised that certain life events can result in "spikes" in a member's accrual, though it plans to limit the situations in which concessions will be made.

- **Death benefits** - the annual allowance test will not apply in the year of death. This is welcome news and will protect bereaved dependents from additional tax on any lump sum death benefit or on a survivor's pension coming into payment.

- **Total commutation in cases of serious ill health** - the annual allowance test will not apply where a member with seriously-shortened life expectancy commutes all of his or her accrued benefits for a lump sum.

- **Ill health benefits** - the Government is looking to exempt some ill health benefits from the annual allowance test, although it is concerned to prevent payment of ill health benefits being used as a means of tax avoidance. Further details of how such an exemption will work will be set out in the draft Finance Bill 2011.

- **Redundancy** - enhanced benefits on redundancy will be subject to the standard annual allowance test and will not be exempt.

## AMENDING BENEFITS?

The Government anticipates that most employers will rearrange their remuneration strategies to ensure that the pension benefits of the majority (or all) of their staff do not trigger the annual allowance charge. (The Treasury expects a reduction in the cost of providing tax relief to come from reduced pension accrual among the better paid, rather than through payment of the annual allowance charge.)

The Government is aware of concerns that the amendment powers in some schemes will limit or prevent benefit changes being made. It states that it will "take action if necessary" to address this issue. In light of the short timescale between now and 6 April 2011, an early announcement that trustees will be given an overriding statutory power to make suitable changes would be very welcome.

## PAYMENT OF THE ANNUAL ALLOWANCE CHARGE

A widespread concern with the proposals from this and the previous Government to restrict pension tax relief has been that members of DB schemes who trigger a tax charge on their accrual would be required to pay the additional tax out of their current income - while having to wait until retirement to receive the pension benefit that had been taxed several years earlier. The Government is considering options to permit the tax charge to be paid from the individual's pension entitlement, rather than their current income, including:

- allowing the scheme to pay the charge on behalf of the member at the point at which the charge arises, or

- allowing the excess contributions above the annual allowance, or the tax liabilities, to be rolled up until the member's benefits crystallise.

## PROVISION OF INFORMATION

### Information to members

Where a member's contributions (or deemed value of accrual) to an arrangement exceeds the annual allowance, the scheme will have to provide the member with the value of his or her increased benefits (the "pension input amount") for the relevant year and the previous three years within six months of the end of the tax year. Of course, a member who also contributes to a personal pension may exceed the annual allowance without the occupational scheme being aware of this. Members may request a statement of their pension input amount - and must be given this within three months of the request, or six months of the end of the tax year, whichever is later. As a transitional measure, trustees will be given an additional 12 months (to 6 October 2013) to provide the information about benefits accrued in the 2011/12 tax year.

Overseas schemes will not be required to provide information to members.

### Information to schemes

Sponsoring employers of DB schemes will have to provide information about employees' pensionable pay and benefits and length of service to those schemes by 6 July following the end of each tax year. For the first (2011/12) tax year, the deadline is extended by 12 months until 6 July 2013.

### LIFETIME ALLOWANCE

Although from 2012/13 the lifetime allowance will be reduced from its present level of £1.8m to £1.5m, many other features of the current lifetime allowance regime will remain, including existing limits for pension commencement lump sums and trivial commutation amounts.

### WHAT'S NEXT?

Much of the detail of the Government's proposals is yet to come. The reduced annual allowance and lifetime allowance will be enacted through the Finance Bill 2011, with consolidated draft clauses expected to be published towards the end of 2010. The draft Bill will also include a new exemption for some ill health benefits. Draft guidance and legislation covering some aspects of the new regime is expected imminently (though was not available at the time of writing).

Consultation is expected in November this year on arrangements to make the payment of large annual allowance charges more manageable for schemes and individuals.

Draft regulations setting out the information requirements for pension schemes and employers are expected early in 2011.

Draft legislation repealing the high income excess relief charge provisions will be issued later in 2010.

For employers, trustees and administrators adapting scheme rules, remuneration packages and procedures in time for the 6 April 2011 start date will be challenging.

This note is written as a general guide only. It should not be relied upon as a substitute for specific legal advice.


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