

## **PENSION TAX CHANGES**

### **Version 1**

### **October 2010**

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Significant changes to pension tax relief were announced by the Government on 14 October 2010.

This briefing note provides a summary of those changes, whilst taking a more detailed look at certain aspects of the new regulations.

#### **SUMMARY OF KEY CHANGES**

##### **The Annual Allowance**

1. From April 2011, the Annual Allowance (i.e. the amount of pension funding eligible for tax relief each year) will be reduced to £50,000 (from the current £255,000).
2. This will initially be a fixed amount, but might be increased/indexed over the longer term.
3. Where individuals exceed the Annual Allowance in a given year, unused allowance from up to 3 previous years will be available to offset against the excess provision.
4. Carry-forward will be available against an assumed Annual Allowance of £50,000 for the tax years 2008-09, 2009-10 and 2010-11.

##### **Pension Tax Relief**

5. Tax relief on personal contributions to registered pension schemes will continue to be available at an individual's highest marginal income tax rate (it had been suggested tax relief would be restricted to 40%).

##### **Exemptions**

6. Deferred members will be exempt from the Annual Allowance regime.
7. The Annual Allowance will not be applied in the year of death or in the case of lump sums paid where individuals are diagnosed with serious (terminal) ill health.

##### **Valuation of Defined Benefit Rights**

8. The fixed factor for valuing Defined Benefit accrual to test against the Annual Allowance will be increased to 16 (from the current factor of 10).
9. The "opening value" of an individual's Defined Benefit rights will be revalued, most likely in line with the Consumer Prices Index (CPI).

##### **Annual Allowance Tax Charge**

10. The tax charge for exceeding the Annual Allowance will be a tailored charge, to recoup the full marginal rate of relief an individual has benefited from.
11. This is expected to follow current principles by adding the value of any excess provision to an individual's income for tax purposes.
12. The Government is to explore options which will allow individuals, in some circumstances, to pay any tax charge incurred for exceeding the Annual Allowance out of their pension entitlement, rather than current income.

## Information

13. To help individuals manage their tax affairs, pension schemes will have to provide details of the value of their pension provision.
14. Details will have to be provided automatically for any tax year where the value of an individual's provision under a scheme is more than the Annual Allowance. In other circumstances, details must be given on request.

## Lifetime Allowance

15. From April 2012, the Lifetime Allowance will be reduced to £1.5 million (from the current £1.8 million).
16. It is expected to be frozen at this level, at least for the foreseeable future.
17. The Lifetime Allowance valuation factor will most likely remain at its current level of 20.
18. The Lifetime Allowance tax charges will remain unchanged (55% if paid as a lump sum and 25% if paid from annual pension income, on top of marginal rate tax on the pension income).
19. The maximum tax free cash sum will remain at 25% of the standard Lifetime Allowance.
20. The Government intends to design a protection regime that supports those individuals who have already made pension saving decisions based on the current level of the Lifetime Allowance.

## Trivial Commutation

21. From April 2012, the trivial commutation limit will be de-linked from the Lifetime Allowance (where it is currently set at 1% of the Lifetime Allowance). It will remain at its current level of £18,000.

## IN DETAIL - THE ANNUAL ALLOWANCE

The Government has announced plans to reduce the level of the Annual Allowance to £50,000 from 6 April 2011. Any pension provision in excess of the Annual Allowance will face a tailored tax charge, reflecting the marginal rate of relief an individual has benefited from.

## Valuing Contributions

For individuals in Defined Contribution schemes, it is relatively straightforward to determine the level of contributions (including any payments made on behalf of the individual by a third party or employer) to be assessed against the Annual Allowance.

To assess the deemed value of notional contributions in a Defined Benefit scheme, the entitlement accrued by an individual over any given year is multiplied by a fixed factor. This factor is to be increased to 16 - meaning, broadly, that an increase in annual pension benefit of £1,000 will be deemed to be worth £16,000.

The increase in annual pension entitlement is the difference between:

- The annual pension earned at the end of the year (the closing value of the entitlement); and
- The annual pension earned at the beginning of the year (the opening value), revalued (most likely) by the increase in the CPI up to the end of the year.

The Government have provided a simple example to illustrate this clearly. This example assumes an individual has been a member of her employer's defined benefit scheme with a 1/60th accrual rate for 34 years. In her 35th year, she receives a pay rise of 20% from £60,000 to £72,000. The deemed contribution at the end of the 35th year is calculated as follows:

- Step 1 - Calculate the opening annual pension entitlement

$$£60,000 \times 34/60 = £34,000$$

- Step 2 - Revalue the opening annual pension entitlement. The uprating permissible in this context is likely to be in line with the CPI, so if the CPI increase is assumed to be 2.5%, the pension earned after 34 years will be revalued to £34,850 (£34,000 x 102.5%)

- Step 3 - Calculate the closing annual pension entitlement

$$£72,000 \times 35/60 = £42,000$$

- Step 4 - The increase in annual pension entitlement is £7,150 (£42,000 - £34,850)

- Step 5 - Multiply by the flat factor to get the deemed contribution

$$£7,150 \times 16 = £114,400$$

In this example, the deemed contribution is £64,400 over the Annual Allowance.

### Carrying Forward Unused Allowances

However, where individuals exceed the Annual Allowance in a given year, unused allowances from up to 3 previous years may be carried forward to offset against the excess contributions.

If the individual in the Government's example had received pay increases of 5% per annum in her 32nd, 33rd and 34th years, her contributions over those 3 years would have only totalled £80,600 (£25,200 + £26,800 + £28,600). She therefore has an unused allowance from those earlier years of £69,400 (3 x £50,000 - £80,600) to carry forward.

The individual thus has an effective annual allowance in her 35th year of £119,400 (£50,000 + £69,400), which is sufficient to cover the deemed contribution in that year of £114,400 and still leave £5,000 to carry forward to future years.

The use of unused allowances therefore allows the tax charge in this example to be reduced to zero.

As a point of interest, carry-forward will be available against an assumed Annual Allowance of £50,000 (with revaluation of Defined Benefit accruals to reflect the new factor of 16 and uplifts of opening value) for the tax years 2008-09, 2009-10 and 2010-11 to enable individuals affected in the first years of the regime to benefit from it.

### Calculating the Tax Charge Due from Excess Allowance

If, after taking account of unused allowances, there remains some part of the pensions contribution in excess of the Annual Allowance, a tax charge will be due. Any charge will be calculated at the individual's marginal rate of income tax.

If the individual in the Government's example had had a pay rise of 22%, rather than 20%, then the deemed contribution would have been £125,600. The excess above the Annual Allowance, after carrying forward available unused allowances, would have been £6,200 (£125,600 - £119,400).

To determine the rate of tax charge, the excess would be added to her salary, taking her taxable income to £79,400 (£73,200 + £6,200) which, in this case, remains in the higher rate tax band of 40%. The excess contribution would therefore be charged at 40% and the tax charge due to exceeding the Annual Allowance would be £2,480 (£6,200 x 40%).

The excess over the Annual Allowance (or part of) would be subject to 50% tax, however, if the excess pushed the individual into the 50% tax band. If we assume the individual in the Government's example received a bonus of £74,800, her aggregate income would then be £148,000 and the tax charge on the excess over the Annual Allowance would increase to £2,900 (£2,000 x 40% + £4,200 x 50%).

### Meeting Tax Liabilities

The Government recognises the fact that there will be cases where individuals face substantial tax charges on contributions significantly exceeding the Annual Allowance, but those charges may not be manageable out of current income. The Government therefore wishes to explore options for those individuals to pay the charge out of their pension entitlement, rather than current income.

Although the Government is keen to provide clarity on this issue as soon as possible, it recognises that many employers, pension administrators and affected individuals will have views on this issue and is therefore proposing to consult with interested parties before making final decisions.

## Pension Input Periods

An individual's total annual pension savings are measured by reference to the benefits they have accrued under a pension arrangement during a "pension input period" (PIP). The PIP is normally a 12 month period generally determined by the relevant pension scheme and it is not necessarily aligned to the tax year. As an individual may be a member of more than one pension arrangement, the aggregation of all of their pension input amounts for PIPs ending in the relevant tax year is taken for the purpose of assessment against the Annual Allowance.

Although the new pensions tax regime will start in the 2011-12 tax year, it is possible that the relevant PIP for that tax year for some individuals may already have begun.

To avoid penalising those individuals who find themselves in this situation and have already made pension provision under the current Annual Allowance of £255,000, the Government have introduced transitional rules to take effect for pension savings on or after 14th October 2010.

These transitional rules will not affect anyone who has annual pension savings less than £50,000.

However, for those with provision in excess of £50,000 whose PIP ending in 2011-12 has already started, new rules will apply affecting the contributions that can be made between 14th October 2010 and the end of the PIP. For these individuals, the test of total pension input against the Annual Allowance will be in 2 parts:

- The first part applies to pension savings in respect of all PIPs ending in 2011-12 that are made on or after 14th October 2010. Savings in excess of £50,000 over this period will be subject to the Annual Allowance charge. The factor applied to value contributions in Defined Benefit schemes for the period on or after 14th October will be 16, with revaluation offset to account for inflation.
- The second part of the test applies to the total pension input across all PIPs that end in 2011-12, regardless of whether the savings accrued before or after 14th October 2010. Any savings in excess of £255,000 will be subject to the Annual Allowance charge. For rights accruing in Defined Benefit schemes, a factor of 10:1 will apply to accruals up to 13th October 2010 and there will be no revaluation for inflation.

These rules will apply alongside the existing anti-forestalling regulations which currently affect individuals earning over £130,000 and alongside the facility under the new regime for individuals to carry-forward unused allowance from up to 3 previous years.

## Information Requirements

The Government have proposed measures to help individuals determine whether or not they have exceeded the Annual Allowance.

Where contributions to a pension arrangement exceed the Annual Allowance, the relevant pension managers must provide the individual concerned with details of the extent of their provision, within 6 months of the end of the tax year in question.

In such circumstances, pension schemes must also provide this information for the previous 3 years, to allow individuals to take advantage of the carry-forward facility.

Individuals may also voluntarily request this information, enabling individuals who are members of multiple pension arrangements to comply with the new regime. In such circumstances, pension schemes must provide the information requested by the later of 3 months from the request and 6 months from the end of the tax year.

However, as the Government recognises that some schemes may not be able to change their systems and processes in time to provide the information to individuals in the first year, it has been decided that, for the first year only, pension schemes will be given an additional 12 months to provide this information.

In these circumstances, if individuals do not have the required information in time to file their 2011-12 tax return, they will be able to use the existing process within Self Assessment to use an estimated figure in their return. Individuals will then have up to 12 months from the filing date to amend their return to reflect the final figure and pay any additional tax and interest due, or have a refund of any overpaid tax.

## **IN DETAIL - THE LIFETIME ALLOWANCE**

The Government plans to introduce the reduced Lifetime Allowance of £1.5 million from April 2012.

However, in order to safeguard individuals who have already made pension saving decisions based on the current Lifetime Allowance of £1.8 million, a protection regime is proposed to avoid any excess accrued over the new threshold being subject to a tax charge (subject to a cap at the level of the existing Lifetime Allowance).

The Government also believes that individuals who are currently protected by primary protection and/or enhanced protection should continue to receive these protections. Individuals were given the opportunity to apply for primary and/or enhanced protection when the Lifetime Allowance was first introduced at its initial level of £1.5 million in 2006.

The Government are to consult with interested parties on this matter before publishing final details.

## **FURTHER INFORMATION**

If you would like to read the Government proposals in all their glory, they can be viewed at [http://www.hm-treasury.gov.uk/d/restricting\\_pensions\\_summary141010.pdf](http://www.hm-treasury.gov.uk/d/restricting_pensions_summary141010.pdf).

If you have any questions about the new pension tax regime, you can email us at [pensiontaxchanges@balpa.org](mailto:pensiontaxchanges@balpa.org). We do not promise to answer every question individually, but we are hoping to provide generic answers to the majority of queries by publishing (and regularly updating) a Q&A sheet covering the most frequently asked questions.

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