Pensions for higher earners

Managing the new limits

The new lower limits for tax relief on annual pension savings that apply from 6 April 2011 raise real and immediate challenges for how employers approach the pension element of senior employees' remuneration packages.

Key changes

The annual allowance limit for pension savings in a registered pension scheme in any tax year from 2011-12 will be reduced from £255,000 to £50,000 (the limit). However, any unused portion of the £50,000 allowance in any of the three preceding tax years will also be added to the limit. Income tax at the marginal rate will apply to the value of any pension savings in a tax year that are over the limit.

For a defined benefit (DB) scheme, the value of pension savings will be determined at the rate of £16 for each £1 of pension accrued during the year (up from the current £10). For a defined contribution (DC) scheme, the value will remain the sum of employer and employee contributions.

Impact on DB schemes

For those employers that still operate a DB scheme, it is common to offer 1/60th of final salary for each year of service. For a single year, this means that a salary of over £187,500 would be needed to breach the limit. However, where a member has some service, the impact of a salary increase means that the value of the 60ths already built up also increases. (DB scheme benefits already built up can be increased by reference to the consumer prices index increase, but any additional increase counts towards the limit.)

So an employee on a much lower salary could breach the limit if he receives a promotional salary increase. However, the ability to bring the unused allowance from the last three years into count means that a promotional pay increase is unlikely to result in a tax charge unless the employee is already building up his pension each year close to the limit.

Some senior employees will breach the limit year on year. Where they do, the ultimate total tax charges on the excess (including tax on the pension in payment) are likely to range between 70% and 100% (depending on the options that the member chooses on retirement and the way in which the initial tax charge is met).

In addition, many employees will face a significant tax charge if they take enhanced early retirement on incapacity grounds, as any increase in the pension (for example, by crediting the member with additional years of service) will count towards the limit. Employers may wish to consider whether to replace incapacity retirement provision generally under DB schemes with some form of permanent health insurance.

Options for DB schemes

There are a range of different options for employers. The obvious ones are:

Do nothing. Some employers may take the view that an employee's tax position is his own business, and that the employer offers a pension scheme which the employee can choose to be a member of or not. However, as DB schemes are not normally a cheap benefit for an employer to provide, undermining the value in the employees' eyes may reduce the DB scheme's effectiveness as a retention tool for key senior employees.

Offer a cash supplement instead of a DB scheme pension for future service. Many employers may find this attractive, not least as it limits growth in DB scheme liabilities. However, such an "all or nothing" approach may be less attractive for employees who value DB pension provision and who may be concerned about the impact on their death benefits. Employers may choose to maintain these death benefits and offer a lower cash supplement.

Pricing the cash supplement will also need careful consideration. A possible pricing basis may be by reference to the transfer-out factors used by the DB scheme.

Employers will also need to ensure that any potential age discrimination issues (under the Equality Act 2010) are identified and managed appropriately. (Payment of a cash supplement that is age-related will, on the face of it, constitute direct discrimination, although this may be objectively justified.)

Limit the increase in DB scheme benefits to £50,000 in any given year and offer a cash supplement on the excess. This is likely to be attractive from an employee's perspective, and does to an extent limit growth in DB scheme liabilities. Again, employers may decide to maintain death benefits and will need to price the cash supplement carefully.

Limit the increase in DB scheme benefits to £50,000 in any given year and provide some form of unregistered EFRBS to make up the difference. This approach maintains the full pension promise that the employee is expecting, although it entails greater administrative complexity. If, in any year, accrual was less than £50,000, any excess would be used to rebuild the member's pension under the DB scheme (and reduce the EFRBS (employer-financed retirement benefits scheme) pension).

An unfunded EFRBS is likely to be the most attractive top-up vehicle for

This article first appeared in the March 2011 issue of PLC Magazine.

employers, because contributions to a funded EFRBS do not receive corporation tax relief until the benefit is actually paid, and because it would be easier to vary the EFRBS pension if it was unfunded. Also, the government is looking closely at funded EFRBSs and may make them less attractive in future (*see also Briefing "Disguised remuneration: is there still a future for employee benefit trusts?", this issue*). However, there is a trade-off for the employee if the top-up is provided by way of an unfunded promise: lower tax for less security.

DC schemes

For a DC scheme, even a combined contribution of 15% of salary will require a salary of over £330,000 to reach the limit in any given year, so very few employees are likely to be affected.

If an employee is affected, the employer is likely to adopt one of two approaches:

- Do nothing, and leave the employee to manage his own tax affairs. The employee may choose to make the full contributions in the hope that tax-free investment returns and the ability to take 25% of the fund tax free outweigh the potential tax detriment at retirement.

- Offer a cash alternative. The employee may choose between investing the contributions in the DC scheme and receiving cash equal to the excess over the limit. Where an employer offers to match contributions up to a certain level (say, to a maximum of 5%), it may only be prepared to pay the full excess if the employee makes the maximum matchable contributions into the DC scheme.

Clock already ticking

For some individuals, this new regime is already effectively in force. Where they have a pension input period (that is, the period by reference to which members' pension inputs can be measured against the annual allowance (*section 238, Pensions Act 2004*)) which has already started and will end after 5 April 2011, all pension savings after 13 October 2010 will be tested against the limit.

Planning ahead

In deciding which approach is best, employers need to consider carefully the affected population and the total reward package offered. They need to reach a conclusion and communicate with affected individuals promptly.

Realistically, only a few very senior individuals are likely to be affected by the changes to the annual limit. For a DB scheme, if they are all close to retirement, the EFRBS approach may perhaps seem relatively straightforward. Other alternatives may be preferable if there is a significant number likely to be affected for a significant period.

As an aside, from 6 April 2012, the limit on total lifetime pension saving in registered pension schemes will reduce from £1.8 million to £1.5 million, with some limited transitional protections available. Decisions about how to deal with the annual limit may be seen as setting a precedent on how employers will address the lifetime limit changes.

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