Changes to the Tax Treatment of High Earners

Overview

The Government announced its proposals for the tax treatment of high earners on 14 October.

Most of the announced changes are more generous to members than the proposals the Government trailed in July. For example:

- the new annual allowance will be £50,000 (above the range of £30,000 to £45,000 suggested in July);
- the factor used to value defined benefit pension saving will be 16:1 (towards the bottom end of the 15:1 to 20:1 range suggested in July); and
- members who do not use up their entire annual allowance in one year will be allowed to "carry forward" the unused part for up to three tax years, in order to offset any later "spike" in their accrual due, say, to a one-off pay rise.

As a result, in practice the new annual allowance charge seems likely to bite less often than many feared.

There will also be full tax relief on pension saving which is within the annual allowance: the Government is not pursuing the suggestion that marginal tax relief should be restricted to 40% for very high earners.

But some aspects of the announcement may come as more of a mixed blessing.

For some schemes and individuals, aspects of the new annual allowance regime may effectively come into play from 14 October (depending on their "pension input period" – see below). For many others, it may come into play well before 6 April 2011. As much of the detail was only announced on 14 October (and even now some points remain unclear), few schemes will have adjusted their benefit structures to avoid the issues that may arise.

In addition, in future schemes and employers will have new disclosure requirements imposed on them to help members work out whether they are caught by the new annual allowance charge.

The Government has also announced a reduction in the lifetime allowance from the current figure of £1.8m to £1.5m. This change will take effect from 6 April 2012. The 20:1 factor used to value defined benefit pensions for testing against the LTA will remain in force.

Finally, there will also be changes to the way employer financed retirement benefit schemes (EFRBS) are treated. Initial legislation will target funded EFRBS, although the position of other EFRBS will be closely monitored.

The tables at the end of this briefing set out the key features of the new regime at a glance.

The Annual Allowance

The new annual allowance will be set at £50,000 (down from the current level of £255,000). Pension saving below that limit will enjoy full tax relief, even where the individual is a 50% taxpayer. But members will be taxed at their full marginal rate of income tax on any pension saving above that limit, whether paid for by an employer or by a member's own contributions. It will hardly ever be tax-efficient to exceed that limit, because the member's pension will be taxed again when it is paid out.

However, there is an important rider to the £50,000 limit. Members will be able to "carry forward" any unused annual allowance for up to three tax years. For example, if a member's pension saving in each of three successive tax

years is only £20,000, they will have £30,000 of unused annual allowance for each of those years. Under the "carry forward" rule, in the fourth year the member could have pension saving of up to £140,000 (i.e. £50,000 plus 3 x £30,000) without an annual allowance charge applying. This will help mitigate the tax charges that could otherwise easily arise in a final salary scheme where a member with long service receives a substantial pay rise. It may also allow members of money purchase schemes to make extra contributions in years where they can (for example, if they receive a significant bonus).

The Government does not expect many people to be caught by the new annual allowance in practice, but it recognises that there may be circumstances where this could occur and where it would be hard for the individual to meet the charge out of current income. The Government is therefore going to consult further over the coming months about ways for people in this position to pay the tax charge out of their pension savings.

HOW WILL "PENSION SAVING" BE VALUED?

In three cases, the answer will be straightforward.

- In a money purchase arrangement, the member's pension saving will be the total of member and employer contributions paid in.
- Deferred members will have no pension saving provided the revaluation of their deferred pensions is within the "relevant percentage". The default relevant percentage is by reference to the increase in CPI, but where scheme rules on 14 October 2010 already provided for a different rate of revaluation, schemes will be able to use that rate instead. (Note that this rule will only apply to a "true" deferred member, where any increase to deferred pension rights is not a function of still being in service.)
- Pensioner members will also have no pension saving when their pension in payment increases each year, but the Government has said it will bring in anti-avoidance legislation to ensure that exceptional increases are caught.

The more complicated case is working out the amount of an active member's pension saving in a period under a defined benefit arrangement. This will involve first calculating the increase in the member's pension from the start the period to the end of the period (after uplifting the starting figure in line with annual CPI inflation at the previous September), and then multiplying the result by a flat factor of 16 (rather than the current factor of 10).

The use of CPI to uplift the starting figure could be an issue for some CARE schemes that revalue earnings by reference to RPI; until now accrued pension rights were effectively "invisible" for annual allowance purposes, but now any difference between RPI and CPI will count towards the annual allowance.

EXEMPTIONS FROM THE ANNUAL ALLOWANCE

The current general exemption from the annual allowance in the year benefits are drawn is being removed, but a number of specific exemptions will still apply:

- The annual allowance will not apply in the year in which a member dies or is diagnosed with terminal ill-health. As a result, any pension enhancements paid in these circumstances will not give rise to an annual allowance charge.
- The Government has also accepted that, at least the case of retirement due to "major" ill heath, payment of enhanced benefits should not be caught by the annual allowance – but the details here are still awaited. This may create uncertainty for cases that are already in the pipeline, particularly where the new regime comes into play sooner than April 2011.

Additionally, it seems that the "enhancement" involved in paying benefits early without actuarial reduction will not trigger an annual allowance charge.

Those exceptions aside, there will be no special exemption for enhancements triggered by a member's redundancy, or for members who wish to "sacrifice" a termination bonus by paying it into a pension scheme.

Nor will there be any special exception for members who elected for so-called "enhanced protection" of their pre 6 April 2006 benefits until they become deferred members proper. In future, where they are not "true" deferred members, any increase in their accrued pension rights will have to be tested each year against the annual allowance.

NEW INFORMATION REQUIREMENTS

Schemes will have to provide members with information about their pension savings, not just for the last tax year but also for the three previous tax years, so that members can work out whether they have exceeded the annual allowance.

This information will have to be provided automatically where the individual has pension savings over the annual allowance in a pension arrangement under the scheme. In this situation, the scheme will have to provide it within six months of the end of the tax year (i.e. by 6 October).

The scheme will also have to provide that information at the member's request, even if the individual has not exceeded the annual allowance under the scheme, as the member might have pension saving under other arrangements and the total might take him or her over the annual allowance limit. In these cases, this information must be provided to the member by the later of 3 months from the date of the request and 6 months from the end of the tax year. Members will be entitled to make one such request a year free of charge.

In addition, employers will be required to give defined benefit schemes information about employees' "pensionable pay and benefits, and length of service" automatically. They will be required to provide this information by the 6th July following the end of the tax year, to ensure that the schemes themselves can comply with their own new disclosure requirements.

For the first year only, employers and pension schemes will be given an additional 12 months to provide the required information, so schemes will have until 6 October 2013 and employers will have until 6 July 2013 to provide it. In the meantime, employers and schemes should start to think about how they will be able to ensure they can provide this information in time and on an accurate basis.

WHEN DOES THE NEW REGIME COME INTO EFFECT?

The biggest surprise of the Government's announcement is buried in the technical detail. It has been generally assumed that the new annual allowance regime would come into play only from 6 April 2011. In fact, in some cases the new rules effectively came into operation on 14 October 2010, as the Government has not chosen to change a little-known feature of the pre-existing annual allowance legislation relating to so-called "pension input periods".

The pension input period is the period over which a member's pension saving under a particular pension arrangement is measured for annual allowance purposes.

Although a pension input period is typically a 12-month period, it is not necessarily aligned with the tax year. Where the pension input period for an arrangement ends on a date other than 5 April, a member's pension saving under that arrangement for a given tax year is deemed to be his or her pension saving in the pension input period which *ends in that tax year*. Members of the same scheme may not have the same pension input period and, indeed, a single member could have different pension input periods for defined benefits and money purchase AVCs under the same scheme.[1]

Scheme administrators can make life easier by nominating the same pension input period for all their members. But many schemes will not have nominated a common pension input period because they assumed that the current £255,000 annual allowance was never likely to be relevant to their members. The reduction of the annual allowance to £50,000 may now prompt schemes to consider nominating the same pension input period for all members.

Where the next pension input period will start before 6 April 2011, the new annual allowance rules will start to apply as soon as that new pension input period begins. There are transitional provisions to deal with pension input

periods which started before 14 October 2010 and which will end on or after 6 April 2011: in these cases, the rule is essentially that the member's pension saving in the part of the pension input period after 14 October 2010 must not exceed the new annual allowance.

Schemes should check now that they can identify their pension input period and whether any different periods apply to individual members. Some schemes may still have scope to adjust these in order to simplify administration.

ANTI-FORESTALLING

Additionally, the current "anti-forestalling" regime (which effectively stops those with incomes exceeding £130,000 from materially increasing their regular pension saving) will continue to apply in full until 6 April 2011, even where aspects of the new regime apply before then. Care should continue to be taken when considering any changes that apply to individuals with incomes above that level.

The Lifetime Allowance

The lifetime allowance will be reduced from 6 April 2012 from £1.8 million to £1.5 million.

Defined benefits will continue to valued using a 20:1 factor, and the tax charges for exceeding the lifetime allowance will remain the same (55% if paid as a lump sum, 25% if paid as annual pension income, on top of the marginal income tax rate).

Maximum tax free cash will continue to be 25% of the lifetime allowance, so a reduction in real terms from a possible £450,000 down to £375,000.

However, the trivial commutation limit will cease to be defined as 1% of the lifetime allowance; instead it will remain at its current level of £18,000.

There will be a new protection regime for individuals who have already built up pension savings above the new £1.5 million limit, and for individuals who expected the pension savings they have already made to grow above £1.5 million due to investment return. The Government is considering allowing these individuals to apply for a personal lifetime allowance of £1.8 million, on the condition that they make no further contributions and cease any further defined benefit accrual.

The Government will also maintain the current primary and enhanced protection regimes, made available when the lifetime allowance was introduced in 2006. However, the removal of the annual allowance exemption for those who have claimed enhanced protection may mean that schemes have to revisit the benefit structures in place for these individuals.

Unregistered Pension Schemes (Efrbs)

An Employer-Financed Retirement Benefits Scheme ("EFRBS") is an unregistered pension scheme which operates outside the lifetime allowance and annual allowance regimes. Broadly, an EFRBS can take one of three forms – a funded EFRBS (where contributions are actually paid to a trust for the member's benefit), an unfunded EFRBS (normally, a simple contractual promise by the employer to make certain payments in retirement) or a secured EFRBS (where an unfunded promise is backed by assets put outside the employer's control).

There are some tax efficiencies, including:

- Income tax on payments is charged at the marginal rate – which will be less than would be payable on benefits above the lifetime allowance;
- There are no limits on accrual in any year (although corporation tax relief is only available when benefits are actually paid);
- Benefits are normally paid without any National Insurance charge, provided that the "shape" of the benefits (if not the amount) meet the registered pension scheme regime requirements.

The Government is concerned that if it did not take any action against EFRBS, they would be more tax advantaged than registered pension schemes for pension savings above the annual allowance. Leaving the status quo would in its view let people use EFRBS arrangements in

order to disguise remuneration and avoid, reduce or defer income tax and national insurance contributions.

The Government has made it clear that it is planning to take action against funded EFRBS in Finance Bill 2011, to ensure that funded EFRBS are (at best) no more attractive than other forms of remuneration and to maintain the principle that there is a limit on the level of tax-advantaged retirement saving the Government is willing to support. It has also said that it will keep all other forms of EFRBS under review.

Employers who may have been using EFRBS to provide top-up accrual, or who were thinking about using EFRBS to ameliorate the impact on their high earners of this latest round of changes, may need to review very carefully their benefit packages in the light of this step.

Endnote

[1] An individual member's pension input period depends on when they started accruing benefits in the scheme (if it is a defined benefit scheme) or when the first contribution was made for or by the member (if it is a money purchase scheme) unless the scheme administrator has nominated a different pension input period. Although, with a money purchase scheme, members can also nominate their own pension input period and so may get in first with a different period. This can get complicated and, with more members potentially affected by the reduction in the annual allowance, it will become more of an issue in future. The Government had looked at aligning the pension input period with the tax year but some in the industry raised concerns about the administrative cost of doing that and the idea was dropped.

The New Annual Allowance At A Glance

ANNUAL ALLOWANCE:	£50,000
Tax relief on pension saving below Annual Allowance	Full marginal relief (i.e. no tax paid)
Tax relief on pension saving above Annual Allowance	None – full marginal tax rate applies
Valuation of new DB pension accrued:	16 x the new DB pension accrued over the year
Measure of new DB pension accrued:	The difference between the DB pension at year end and the DB pension at year start uplifted by CPI inflation
Valuation of new DC accrual:	Total of member + employer contributions
Treatment of deferred members:	Normal revaluation will not count towards the annual allowance.
Can unused Annual Allowance be carried forwards?	Yes – for up to three tax years. So if a member's "pension saving" in three successive tax years is only £20,000, and he then has pension saving in the fourth year of £100,000, no AA charge will be due because, carrying forward his £30,000 of unused annual allowance from each of the previous three tax years his annual allowance in the fourth year is effectively £140,000 (=£50,000 + 3 x £30,000)
Treatment of any enhancement on member's death	Not taken into account
Treatment of any enhancement on early retirement or serious ill-health (life expectancy less than a year)	Not taken into account
Treatment of any enhancement on early retirement or "major" ill-health	Likely not to be taken into account, but no clear statement yet of what is "major" ill-health
Treatment of decision not to apply an actuarial reduction to a DB pension taken early	Not taken into account
Treatment of any other enhancement e.g. on redundancy	Could attract annual allowance charge but only if value of enhancement exceeds annual allowance (but "carry forwards" rule may mitigate the effect)
Treatment of "spikes" in accrual	Could attract annual allowance charge but only if value of enhancement exceeds annual allowance (NB "carry forwards" rule may mitigate its effect)
When does this take effect if current pension input period began before 14 October 2010 and ends before 6 April 2011?	When new pension input period starts. (NB Anti-Forestalling charges may apply if benefits are changed before 6 April 2011)
When does this take effect if current pension input period began before 14 October 2010 and ends after 5 April 2011?	Now! But an annual allowance charge will apply only if either pension saving (valued on the 16:1 basis) between 14 October 2010 and the end of the pension input period exceeds the annual allowance ("carry forwards" may be available) or total pension saving in the pension input period (on the 10:1 basis where it occurred before 14 October 2010 and on the 16:1 basis where it occurred on or after 14 October 2010) exceeds £255,000.

The New Lifetime Allowance At A Glance

THE NEW LIFETIME ALLOWANCE:	£1.5 MILLION
How will money purchase (and cash balance) pots be valued for LTA purposes when they crystallise?	As now – the value of the money purchase (or cash balance) "pot"
How will defined benefit lump sums be valued for LTA purposes?	As now – the cash sum actually paid
How will defined benefit pensions be valued?	As now – 20 x starting pension
What will be the tax charge when benefits exceed the LTA?	As now – an extra 25% tax if excess is paid as pension income, and 55% if excess is paid as cash.
Will this affect the 1% LTA limit on trivial commutation lump sums?	The TCLS limit will remain £18,000. It will not be reduced.
When will this come in?	6 April 2012
Will there be protection for those who have already elected for primary or enhanced protection?	Yes
Will there be protection for those already over the £1.5m limit?	Yes
What if a member's pot is below £1.5m but he or she hopes the money purchase element will increase beyond that limit with investment return?	It seems likely that the member will be able elect to keep the £1.8 million limit provided he or she stops making any contributions.

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