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News on new pension taxation

Technical news – October 2010

In a nutshell

HM Treasury (HMT) and HM Revenue and Customs (HMRC) announced details of the measures to be taken to restrict pensions tax relief on 14 October 2010. This confirms that an approach based on a reduced annual allowance (RAA), as suggested in the emergency Budget and July discussion paper, will be adopted.

From 6 April 2011, the annual allowance (AA) will be reduced to £50,000 and, for testing against it, defined benefit pension accrual (DB) will be valued using a flat factor of 16.

The lifetime allowance will be reduced to £1.5 million, probably from April 2012 and retaining the existing factor of 20:1 for valuing DB pension accrual, with transitional provisions.

Within the reduced annual allowance, tax relief will still be given at the individual's marginal tax rate (rather than being restricted to 40%, as had been suggested).

Schemes will be able to retain their existing 'pension input periods' (over which accrual is measured) and will not have to align them with the tax year.

Background

In December 2009, the Labour Government announced radical proposals for reducing tax relief on pension contributions and accrual for "high earners", to take effect from 6 April 2011. The framework for these proposals was incorporated into Finance Act 2011. These were controversial and on 22 June 2010 the Coalition Government announced that it was considering alternative ways of restricting pensions tax relief, in particular by means of a significantly reduced annual allowance. A discussion paper was issued on 27 July 2010 and the conclusions regarding the way ahead were announced on 14 October 2010, with the RAA changes coming in from 6 April 2011 and LTA changes expected from 6 April 2012.

The new regime

<u>Level of reduced annual allowance</u>

The RAA will be £50,000, but there is no commitment to increase this annually in future years. The figure will be reviewed for tax year 2016/17.

<u>DB valuation factor</u>

The factor for valuing DB pension accrual will be 16, regardless of age, pension age, level of indexation in payment or dependants' benefits and the age when the pension actually comes into payment. The use of a single non-age-related factor and a fixed RAA means that the *value* of DB accrual allowed within the RAA will increase as the member approaches retirement, even though the *amount* of additional pension that can be accrued will remain constant. This contrasts with the treatment of defined contribution benefits (DC), where the amount of pension that can be expected to be provided at a given retirement age by a contribution within the RAA will decrease as the member gets older.

Deferred members, revaluation and negative accrual

'Normal' deferred pensions will be exempt from the new RAA tax charge. Allowance will be made for past accrual of DB pensions to be revalued at a maximum rate of CPI increase (at least, that is the rate used in an example). Negative accruals will be counted as zero, but it is not yet clear whether these may be offset against positive accruals in other arrangements when testing against the RAA in any tax year.

Exemptions

Exemptions will apply in cases where benefits are commuted to pay a serious ill-health lump sum and on death, but not for redundancy. Details are still awaited for the treatment of other cases of less serious ill-health. There will not be a general 'final year' exemption for DB, as there is under the existing Finance Act 2004 (FA04) provisions. Members with enhanced protection under FA04 will not be exempt from the RAA requirements (as they were from the original annual allowance). (It is expected that individual transfers and pension credits and debits (following divorce) will be dealt with as they are under the existing AA provisions by adjusting the opening and closing values to eliminate their effect).

Lifetime allowance changes

There is to be a lower lifetime allowance (LTA) of £1.5m from April 2012 (although the Government may be consulting on this) with no commitment to increase this annually in future years. The Government is minded to retain the DB pension multiplier at 20. The rate of the LTA charge will be unchanged from the present level of 55% on lump sum and 25% on capitalised value of pension. There will be transitional protection for those with enhanced or primary protection under the current legislation.

The Government is also considering a new type of protection going forward, which would be simpler (and more robust) than the current protection regime: in order to be protected against charges under the new LTA, there must be no money purchase contributions and active members of DB arrangements must become deferred members (without salary linkage).

Rate of tax charge

The RAA charge will be at rate that will recoup the full marginal rate of tax relief that the member has benefited from, rather than the fixed 40% rate of the original AA charge. This effectively reduces the tax relief enjoyed on pension input above the RAA to zero, which will lead to double taxation (at penal overall rates) on emerging benefits. Tax relief on pension input within the RAA will still be available at full marginal rate, rather than being restricted to 40%, as had been suggested.

Managing pension accrual

The onus will be on individuals and employers to make whatever changes are needed to their pension arrangements so that pension accrual will not normally be expected to exceed the RAA. In DC schemes, the presumption is that contribution rates can easily be reduced to the appropriate level. Accrual under DB schemes might be capped, one-off increases might be phased over a number of years or members likely to be affected could opt-out in exchange for alternative benefits. Where schemes and/or employers are unable to smooth away spikes, there will be a facility to carry forward unused RAA for up to three years. Carry forward will be available against an assumed AA of £50,000 for tax years 2008/09, 2009/10 and 2010/11.

Paying the tax charge

Individuals will be responsible for paying their own tax charges which are expected to be raised under self-assessment. The Government is also considering other options where raising an immediate tax charge would cause difficulties, such as allowing tax liabilities to be "rolled up" to the point of benefit crystallisation. There may be an option for the scheme to pay with member's benefits being reduced, but this is still being assessed by Government.

Anti-avoidance

Devices, such as those mentioned above, to manage spikes in accrual will not generally fall foul of the anti-avoidance regime. Pensions that increase at an exceptional rate will be deemed to be tax avoidance. The introduction of specific anti-avoidance legislation will be considered, if needed to prevent abuse. Tax on funded EFRBS and employee benefit trusts will be amended to ensure that these are no more attractive than other forms of remuneration.

Alignment of pension input periods with the tax year

The pension input period (over which pension accrual will be measured) will not have to be aligned with tax year and schemes will be allowed to retain their existing arrangements. There will be transitional provisions and protections.

Provision of information to scheme members

Scheme trustees and managers will be required to provide statements to members whose scheme benefits exceed the RAA to assist them in completion of their self-assessment returns, within six months from the end of the tax year. Where individuals request this information, pension schemes must provide details on the pension input amount by the later of 3 months from the request and 6 months from the end of the tax year. Employers must provide information about employees' pensionable pay, benefits and service to pension schemes by 6 July following the end of the tax year. For the first tax year only, employers and pension schemes will be given an additional 12 months (i.e. to 6 July 2013 or 6 October 2013 respectively), to provide the required information. Individuals will be able to use estimated figures in this first year as long as they file final figures in the next 12 months.

Other issues

From April 2012 the trivial commutation limit will be de-linked from the LTA limit and will be fixed at its current level of £18,000.