

Pension changes from April 2011

From 6 April 2011, tax relief for pension contributions is restricted

This new provision has an interesting history. The last government announced that tax relief would be restricted to the 20% basic rate of tax for pension contributions for those earning £150,000 a year. This was then reduced to £130,000 in some circumstances. These arrangements were enacted as Finance Act 2010 Sch 2 and added another 22 pages of tax law.

Before this provision could take effect, the new government scrapped it. Instead the tax relief is restricted by reducing the allowances that qualify for pension relief. This is being introduced in two stages:

- the annual allowance is reduced from £255,000 to £50,000 from 6 April 2011
- the lifetime allowance is reduced from £1.8 million to £1.5 million from 6 April 2012.

The former of these is more significant.

With a few exceptions:

- the change does not affect anyone whose pension fund increases by less than £50,000 a year

It should be noted that the annual allowance refers to both the employee's and employer's contribution.

ANNUAL ALLOWANCE CHARGE

Where someone does pay more than this into a pension fund, they will still get tax relief at their highest rate of tax (40% or 50%), but they may have to pay an annual allowance charge (AAC). In effect, this refunds the tax relief above the basic rate.

For example, a company runs a pension scheme where employees contribute 8% of their salary and the employer agrees to provide twice this figure. Adrian earns £250,000 a year.

His contributions are therefore:

Adrian:	8% x £250,000	=	£20,000
Employer	2 x £20,000	=	£40,000
Total contributions			<u>£60,000</u>

So Adrian is liable to the AAC

The annual allowance is related to a pension input period (PIP). This is not aligned to a tax year. As these new provisions were announced on 14 October 2010, there are some transitional provisions to provide relief for individuals whose PIP for 2011/12 had started before 14 October 2010.

BRINGING FORWARD THE ANNUAL ALLOWANCE

The £50,000 is an annual allowance. If the amount is exceeded, any unused allowance for the three previous years may also be used. The current year must be used first. Then the allowances for the three previous years, starting with the oldest. For these purposes, the annual allowance is regarded as £50,000 for all years before 2011/12.

For example, Brenda is self-employed. Each year she decides how much to pay into her pension fund. She had a particularly good year in 2011/12. She makes these payments:

Tax year	Contribution
2008/09	£24,000
2009/10	£36,000
2010/11	£48,000
2011/12	£100,000

All the contributions for years up to 2010/11 are covered by the allowances then in force. For 2011/12, we have to consider the new £50,000 annual allowance. Her relief is calculated thus:

2011/12 contribution		£100,000
less: 2011/12 annual allowance	£50,000	£50,000
less: 2008/09 AA (£50,000 - £24,000)	£26,000	£24,000
less: 2009/10 AA (£50,000 - £36,000)	£14,000	£10,000
less: 2010/11 AA (£50,000 - £48,000)	£2,000	£8,000

This means that she must pay an AAC based on £8,000 unrelieved pension contributions.

DEFINED BENEFIT SCHEMES

Some pensions are defined benefit schemes. These are also known as final salary schemes. Here the contribution is not defined; only the benefit is. The benefit is usually given as a tax-free lump sum and an annual pension. Each of these is calculated as a fraction of pensionable earnings. Such schemes are now largely only found in the public sector, though some long-serving employees in large companies may still be in such a scheme.

The annual allowance is considered according to the increase in value of the pension value during the year. The annual pension is calculated by multiplying the current value of the annual pension by a factor of 16. The opening value is increased by the rate of inflation as measured by the Consumer Price Index (CPI), not the retail prices index (RPI).

Any amounts that relate to ill health cover are excluded.

For example, Colin is a teacher. His scheme provides for a lump sum of 3/80 of his pensionable earnings for each year of service, and an annual pension based on 1/80 for each year of service. At the start of the year he was earning £50,000 after 20 years' service. During the year, he was promoted to a salary of £60,000. The CPI for the year was 3%.

Opening value of pension fund		
Annual pension: 20/80 x £50,000	=	£12,500
Multiplied by a factor of 16	=	£200,000
Lump sum: 20 x 3/80 x £50,000	=	£37,500
Total value of pension fund		£237,500
uplifted by 3% CPI (ie multiplied by 1.03)		£244,625

Closing value of pension fund		
Annual pension: 21/80 x £60,000	=	£15,750
Multiplied by a factor of 16	=	£252,000
Lump sum: 21 x 3/80 x £60,000	=	£47,250
Total value of pension fund		£299,250

Increase in value of pension fund		
Closing value		£299,250
less opening value		£244,625
Increase in value		£54,625

So Colin could be liable to the AAC as his pension has increased by more than £50,000 during the year. He may be surprised that a £10,000 a year pay rise generates a £54,625 increase in pension valuation.

In practice, he is likely to have unused allowances from the previous years and so will pay no extra tax. Nevertheless, this example shows that defined benefit schemes can trigger the new tax charge even on fairly low sums. Colin's increased salary is less than half the £130,000 threshold previously announced.

CALCULATING THE ANNUAL ALLOWANCE CHARGE

The annual allowance charge is added to the taxpayer's other taxable income and taxed accordingly.

For example, Diana has reduced net income of £130,000 for the year. This figure is her taxable income less her personal allowance and any other reliefs and allowances.

Her annual allowance charge is £40,000. This is the amount of her pension contributions for the year less £50,000 for the current year and less any unused amounts from the three previous years.

Her tax is:

Balance of the 40% band: £150,000 threshold - £130,000 =	£20,000
Tax at 40% =	£8,000
Balance taxed at 50%: (£130,000 + £40,000) - £150,000 =	£20,000
Tax at 50% =	£10,000
Additional tax	£18,000

So Diana will pay an extra £18,000 tax in respect of her pension contributions in addition to her other tax liabilities.

POINTS TO NOTE

The main points to note are:

- taxpayers continue to receive tax relief at their full marginal rate on contributions, but may now have to pay tax on an annual allowance charge
- in general, this does not affect taxpayers whose pension fund contributions are less than £50,000 a year
- if contributions do exceed £50,000, any unused allowance for the three previous years may be used
- defined benefit schemes can result in large increases in pension fund values on relatively small increases in pay
- defined benefit schemes have a new obligation on reporting fund values to members
- even if contributions are within the £50,000 a year limit, a tax charge can arise if the cumulative contributions exceed the lifetime limit
- contributions that arise on redundancy are included in the reckoning

There are many other implications that may need to be considered. These include converting a final salary scheme to a money purchase scheme, adjustments for Gift Aid payments, and transitional provisions for certain high value existing schemes. There are also administrative provisions and anti-avoidance provisions that need to be considered.

There are provisions that allow pension funds to smooth out any "spikes" in pension fund accruals, subject to anti-avoidance provisions.

There are also anti-forestalling provisions that prevent someone paying in large sums of money to a pension fund before 6 April 2011 to avoid the new tax charge.

We can advise on all these other implications, in addition to explaining any of the above matters as they relate to your circumstances.

It should also be noted that this is not the only change in pensions being introduced. Other changes are:

- the increase in state retirement age for women from 2010 and for men from 2018
- the raising of annuitisation threshold from 75 to 77 for the current year, and its proposed abolition next year
- the introduction of the NEST employment pension schemes from 2013
- differential earnings thresholds for national insurance from 6 April 2011.

We can advise on all these changes and on other pension matters.