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**Budget 2016**

**PENSION TAX CHANGES**



**DOYLE CLAYTON**

## PENSION TAX CHANGES

### What are the changes?

With effect from 6 April 2016, there will be further changes to the rules on the Annual Allowance (AA) limits. There are also plans to reduce the Lifetime Allowance (LA) from the current level of £1.25m to £1m for everyone, regardless of what they earn. The enabling legislation for the LA limits, however, is still in draft<sup>1</sup> and should make its way through parliament this spring and receive Royal Assent shortly thereafter.

The new AA rules will not apply to anyone with a *threshold income* of less than £110k and the tapering will only start on any amount of the *adjusted income* over £150k from its standard amount of £40k down to £10k. We look at what constitutes *threshold income* and *adjusted income* in more detail below.

The AA is a limit on the total amount of contributions that can be paid to defined contribution pension schemes and on the total amount of benefits that can be built up in defined benefit pension schemes each year, for tax relief purposes. The LA is a limit on the amount of pension benefit that can be drawn from pension schemes, whether as lump sums or retirement income, without triggering an extra tax charge.

### What do the changes mean?

The government's stated aim is to reduce its pension tax relief bill, which currently stands at £35 billion. The latest changes will severely curtail a person's ability to make adequate pension provision for their retirement through their current pension arrangements. The general perception is that the changes affect only high earners, but critics of these changes say that reducing tax incentives to save for old age is a bad idea (and counterintuitive to government policy) because it sets a limit on people's ambition to get a decent pension without having to rely on the state. The constant lowering of the tax free limits means that more people will reach the limit more quickly, which, is a disincentive to long term saving. Also, taking into account monetary inflation the current limits will affect the vast majority of people in 20 years' time.

Broadly, if an individual exceeds the AA in a year, they will not receive tax relief on any contributions they paid that exceed the AA limit and they will be faced with an AA charge. The AA charge will be added to the rest of their taxable income for the tax year in question, when determining their tax liability. The amount of the AA charge can be in whole or in part at 50%, 40% or 20% depending on the individual's taxable income and the amount of their pension savings that exceeds the AA for the year concerned.

Any pension savings above the LA are subject to the LA charge, which will continue to be levied at a rate of 55% if the excess is taken as a lump sum, or 25% if the excess is taken as income.

### Who does it affect?

As mentioned, the new rules will not apply to anyone with a *threshold income* of less than £110k and the tapering will only start on any amount of *adjusted income* over £150k.

### How the "threshold income" is calculated

The threshold income is calculated as follows:

- net income PLUS

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<sup>1</sup> Clause 12 Finance Bill 2016

- the gross amount of any salary sacrifice arrangement for pension provision LESS
- the amount of any relief at source<sup>2</sup> pension contribution LESS
- the amount of any lump sum death benefit that would have been paid to the individual because the member died after age 75.

In order to calculate 'net income' for the tax year, from the individual's total income for that tax year deduct all applicable reliefs and allowances, which will result in the individual's total pre-tax income. Therefore if a person does not have a threshold income of £110k then the adjusted income calculation is irrelevant.

### **How the "adjusted income" is calculated**

The adjusted income is calculated as follows:

- net income (calculated as under threshold income above) PLUS
- any relief given as net pay arrangements<sup>3</sup> pension contribution PLUS
- any relief for overseas pension contributions PLUS
- the value of any employer pension contribution.

### **How will the taper work?**

The taper will reduce a person's AA by £1 for every £2 by which their adjusted income exceeds £150k, up to a maximum £30k reduction. For example, a person with an adjusted income of £210k (and who has not flexibly accessed any DC pension rights) will have an AA fixed at £10k, whereas someone with an adjusted income of £180k in the same example will have an AA of £25k.

### **What else will be changing?**

The Pension Input Period (PIP), which is generally the 12 month period assessed for pension inputs for final salary accrual and money purchase contributions, will be aligned with the tax year, rather than individual scheme years. All PIPs ended on 8 July 2015, but there are transitional arrangements.

### **What are the transitional arrangements?**

The transitional arrangements are complex. There are transitional PIPs and AA arrangements for the pre-alignment tax year (6 April 2015 to 8 July 2015) and the post-alignment tax year (9 July 2015 to 5 April 2016). Post 6 April 2016, the PIP will be aligned with the tax year.

For the transitional AA arrangements, the Government has effectively created for the 2015/2016 tax year, a temporary £80k AA, plus any unused AA carried forward from the previous three tax years. Normally, if you are on a salary that allows you to make such large contributions into your pension, and you wanted to make an extra pension contribution of £40k, this would attract a 45% tax charge, or in monetary terms £18k. This temporary AA is being created by the government in order to address anomalies in the pension system, such as aligning the PIP with the tax year and not the different scheme years. What this effectively means is that anyone who has already put in £40k in the current tax year will get another chance to make a £40k

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<sup>2</sup> Relief at source arrangements essentially require net contributions which means that the employer first deducts tax under PAYE and then deducts the net contribution. Such an arrangement is used by group personal pension plans and other contract based arrangements.

<sup>3</sup> Net pay arrangements essentially require gross contributions which means that the employer deducts gross member contributions before deduction of tax via PAYE. Such arrangements are used primarily by trust based occupational pension schemes

contribution to their pension scheme, tax free. From 6 April 2016, the standard AA of £40k will apply together with any unused allowance.

However, if an individual is lucky enough to be in a position where they can use the temporary £80k limit and carry forward their unused allowance from the previous three years, there are some other tax rules to consider.

An individual is only supposed to make annual contributions into their pension up to the level of their current salary. If you are an employee, your employer could help to make the payments or if you are a business owner, you could arrange the payment yourself.

It is also worth noting that an individual has to use up all their AA in the current year before they can start using their allowance from the previous years. They also need to have been in a registered pension scheme in order to tap into the unused AA from previous years. This means it will not be possible to set up another scheme such as a SSAS or SIPP to claim the backdated allowances.

### **Action points**

Given the far reaching changes, employers should take the opportunity to identify who might be caught by these changes and what, if anything, they want to do about it. As the government has opened a consultation on further reviews of pension tax relief (discussed below), it seems an opportune moment to take advantage of the transitional and carry forward arrangements, as the government continues with its stated aim of reducing its tax relief bill.

### ***What would an employer need to consider?***

- Employers may wish to identify and provide information and guidance to individuals affected and to whom tapered AA is likely to apply
- Update their systems to deal with the changes
- Decide whether to limit contributions to the DC plan to say £10k per year, and for their DB plans decide whether to restrict accrual for affected staff. If so, changes to scheme rules may be required and given the type of changes that are required, either by using the statutory override or the scheme amendment power. The advantage of using the statutory override is that the employer does not need to consult or agree the changes with the trustees, depending on the specific provisions in the amendment power.
- Consider what other changes they need to make to their scheme rules, for example, whether their PIP is aligned with the tax year. A change will require an amendment to the rules.
- Employers operating salary sacrifice arrangements in connection with their pension plan will also need to work out how that arrangement should be treated for the purposes of calculating the individual's "threshold income". For example, salary sacrifice arrangements renewed or established post 9 July 2015 may need to be included in the calculation of threshold income. New joiners entering into the employer's salary sacrifice arrangements post 9 July 2015 will need to include salary sacrifice arrangements in the calculation of their threshold income.
- Employers operating flexible remuneration arrangements in connection with their pension scheme will also have to work out how that arrangement should be treated for the calculation of the individual's threshold income.
- Given the above, consider whether any follow up changes are required to the contracts of employment

- Check their scheme rules. What do they say in light of the A day changes? Whilst most schemes would have updated their rules in light of the tax simplification provisions which came into force on 6 April 2006, it is worth checking the rules to see whether the old revenue limits post 6 April 2006 have been retained. In the rush for A day changes, some schemes simply retained the old revenue limits and then forgot to update them. The issue here is that if the old limits have been retained, then trustees still need to consider them in the calculation of overall limits and if an individual has a more generous accrual than 1/60ths then he may have already exceeded his limit.
- Formulate their company policy in relation to the individuals affected. There are a range of alternatives, for example, helping the individual to maximise on the transitional arrangements is likely to be the most likely option. There are of course other additional options to consider to make up for the new tax limits, such as additional cash, bonus schemes, corporate ISAs and Family Trusts. Each of these alternatives is of limited use and needs to be considered as part of the overall employee benefit package and their tax effectiveness.
- Family Trusts are for employers who offer 'family' pension plans as part of their flexible remuneration package to employees. These types of trusts have been presented as a possible alternative to the problem of an individual exceeding their LA. As the name suggests, the Trust is a wrapper for a self-invested pension plan that is created for a group or family (including business 'family'). The annual growth within the Trust can be allocated to other members of the group thereby managing the value of each member's LA, so that one individual does not exceed the LA within a relatively short time and each get to maximise their tax free limit.
- Making use of Employer Financed Retirement Benefit Scheme (EFRBS) will be of limited use as the government will consult on tackling the use of EFRBS to obtain a tax advantage in relation to remuneration. EFRBS are unregistered pension schemes, and provide pension benefits to individuals above those allowed by registered pension schemes. They enjoy some tax advantages but not as many as registered pension schemes. They have in the past been used to make loans to the members as a way of accessing the money earlier, however, it is practices such as these that HMRC is looking into. Using them as originally intended may still be an option for some individuals and again can be considered as part of the wider employee benefits package.

***What would an individual need to consider?***

- According to HMRC estimates there are around 300,000 pension savers who have a net income of at least £110k and who therefore will be affected by these changes. However, there is a danger that those who are not affected today may not realise that it may affect them in the long run, meaning that they may not get the pension they expect. These limits should be seen in the context of tomorrow's money.
- Making use of the transitional arrangements (£80k limit) and unused AA going back three years is likely to be the best immediate option for an individual.
- The tax regime for pension schemes changed fundamentally from 6 April 2006. However, the legislation included certain transitional measures designed to protect the benefits that members accrued before 6 April 2006 from the impact of the LA. There were two main forms of protection, i) primary protection and ii) enhanced protection. To obtain either form of protection, an application had to be made to HMRC before 6 April 2009. An individual should consider whether they took out the additional protection at the time and seek relevant advice.
- Consider the use of Family Trusts, outlined above.

**What has been the industry view thus far and what further changes are in the pipeline?**

At face value, the pension tax changes significantly reduce the opportunity for pension saving for high earners. However, opponents of these changes say it is bad for everyone and not just the high earners because it effectively sets a limit on people's ambition to get a decent pension.

£40k seems a large sum to put into a pension in a year but people do at times come into large sums either through inheritance, sale of property or a redundancy payment. Such unexpected sums would be a way of plugging any underfunding gap. The vast majority of people do not use up their full tax free allowance.

A £1m LA limit on benefits may seem like a lot. However, in a DC scheme (and most people have this type of benefit) this would buy you considerably less than a £25k a year annuity, which projected into tomorrow's money will not be very much.

The consensus is that successive governments will come under pressure to review the caps.

It was expected that the March 2016 budget, would contain an announcement about a major overhaul in UK pension taxation. The proposal would be to change the current system whereby contributions and investment earnings are tax free whilst pensions in payment are taxed as income, to a system where the opposite is true. Taxing contributions and investment earnings would provide a huge windfall in tax revenue for the Treasury and would not preclude the possibility that in years to come pensions in payment would become taxable as income.

Another change rumoured was a further cut in the AA to 25k, but that would require a change in legislation at the very least. The 16 March budget has been perhaps unsurprisingly silent on pension tax changes. The reason may be that such changes would have caused a lot of upheaval especially in a climate where auto-enrolment is still bedding down and there is a referendum in June 2016 on the UK's continued membership of the EU. Amongst all this uncertainty, it is worth remembering that the Government has a stated aim to reduce its tax relief bill. Like the certainty of death and taxes, there will be more change to the UK pension tax regime.

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