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The Impact of Budget 2009 on Pensions

Introduction

In his Budget on 22 April 2009, the Chancellor announced the introduction, from 6 April 2010, of a new additional rate of income tax of 50%, applying to taxable income over £150,000. In order to prevent this resulting in an increase to the tax relief granted on pension contributions, the Chancellor also announced that from 6 April 2011, tax relief on pension contributions for high earners will be restricted.

The purpose of this note is to look at the changes to tax relief on pension contributions, along with the 'anti-forestalling' measures that the Government has put in place to limit individuals who may otherwise have been tempted to maximise their tax relief by making additional contributions before 6 April 2011. This note reflects legislation that is currently in draft, so may be subject to change. The note allows for the changes that were proposed on 3 July 2009.

Changes to tax relief on pension contributions

Prior to the Budget 2009, all pension contributions benefitted from tax relief at the individual's marginal, that is their highest, rate of tax.

From April 2011, tax relief on pension contributions will be restricted for those with an annual income of £150,000 or more, with the level of tax relief tapering away so that for those earning over £180,000, tax relief will be at 20%, the same as for a basic rate taxpayer.

In addition, for these individuals, pension contributions paid by the employer will also be taxable, which means they will be effectively treated as a benefit in kind and liable to a tax charge. The implication is that this will be at the rate of 30% (50% additional rate of income tax less 20% basic rate of income tax) for those earning over £180,000 and on a sliding scale between 0% and 30% for those earning between £150,000 and £180,000. From the employer's perspective, employer contributions will continue to be tax deductible expenses.

At this stage, no details have been published relating to the taper scale applying to incomes between £150,000 and £180,000. Although determining the benefit in kind tax charge is straightforward for contributions to money purchase arrangements (such as personal pensions or stakeholder), this is not the case for defined benefits schemes (such as the NHS Pension Scheme), where employer contributions are not allocated to individual members. The Government has indicated that it will consult on the operation of these issues.

Given the current unknowns, the following example can only illustrate how the change in tax relief and benefit in kind tax charge would affect an individual accruing benefits on a money purchase basis.

Example A

Marcus has taxable income of £149,999pa and pays pension contributions (including Additional Voluntary Contributions (AVCs)) of £15,000pa into a money purchase arrangement. His employer pays £10,000 in pension contributions to the arrangement. He currently benefits from tax relief at 40% and as a result, his pension contributions are effectively worth £25,000 [£15,000/(100%-40%) = £25,000].

As long as his taxable income is less than £150,000, he will continue to benefit from tax relief at 40% on his own pension contributions and will not be subject to a benefit in kind tax charge on the employer contributions.

Jackie also pays pension contributions of £15,000pa, her employer £10,000pa but her taxable income is £180,000 pa. With tax relief at 40%, her pension contributions are currently worth £25,000

But from 6 April 2011, Jackie will only be entitled to tax relief at 20% (the basic rate of tax) and her pension contributions will then be worth £18,750pa. [£15,000/80% = £18,750].

She will also be liable to pay a 30% tax charge on the employer contributions.

In other words, the amount of tax Jackie pays will increase by £9,250pa. (£25,000 less £18,750 plus £3000)

Anti-forestalling measures

In order to avoid high earning individuals increasing their pension contributions before the new regulations take effect in April 2011, the Government has introduced new "anti-forestalling" regulations to apply from 22 April 2009, Budget day. These restrictions set an upper limit on the amount of pensions savings for which full tax relief at the current higher rate (40%) will be given.

The remainder of this note will focus on the "anti-forestalling" measures which will apply until April 2011.

Who is affected by the measures?

The vast majority of people will not be affected by these measures. The restrictions will only apply to individuals:

- who have total taxable income in the current tax year, or either of the two preceding tax years, of £150,000 or more; and
- who increase their pension savings above the normal pattern of regular contributions; and
- whose total pension savings in the tax year exceed £20,000.

What do the changes mean?

For individuals caught by the "anti-forestalling" measures, any additional, non-regular contributions above a limit known as the "special annual allowance" will be subject to a 20% tax charge, effectively restricting tax relief on these additional contributions to the basic rate of tax. It is important to note that whilst this is referred to as a tax charge, it is in reality, the clawing back of tax relief which has been given.

What does this mean for any existing pension benefits?

Normal, regular pension savings under arrangements that were in place prior to 22 April 2009 are classified as "protected pension inputs" and are not subject to the special annual allowance test.

To understand who is affected, we need to firstly look at what is meant by total taxable income and we must then consider what constitutes 'normal regular pension savings'.

How is total taxable income defined?

Broadly, this is:

- Total income (salary, investment income, pension in payment etc) before pension contributions, personal allowances and other relief and deductions; less

- any normal deductions for reliefs (such as trading and property losses) including deductions for pension contributions (but subject to a limit of £20,000); less

- any gift aid deductions, as per normal

In addition, any amount of employment income foregone in respect of salary sacrifice arrangements put in place on or after 22 April 2009, must be included in the calculation of total taxable income. Salary sacrifice arrangements in place before 22 April 2009 will not be taken into account.

Examples B

Andy has income of £60,000 in 2007/08, £65,000 in 2008/09, £68,000 in 2009/10 and £75,000 in 2010/11. Since his income is less than £150,000 in all tax years, he is not affected by these measures.

Belinda has total taxable income of £158,000 in 2009/10 and has total contributions (employer & employee) to a money purchase scheme of £15,000 in the tax year. Although her income exceeds the £150,000 threshold, her total contributions are less than the £20,000 limit and therefore she is not affected by these measures.

Clive has total taxable income of £158,000 in 2010/11 and makes contributions to his personal pension scheme of £24,000 over the tax year, as he has done for the previous two years. His income exceeds £150,000pa and his pension contributions are more than £20,000, so these measures may affect him, but this will depend on whether his contributions meet the requirements of 'normal regular pension savings'.

What constitutes normal, regular pension savings?

The definition of normal, regular ongoing pension savings depends on the type of pension arrangement in place.

For money purchase arrangements, contributions paid (by both the individual and the employer) count as normal regular pension savings, providing the contributions were paid at least quarterly before 22 April 2009 and continue to be, that there is no increase in the rate of contributions paid or, where there is an increase, that the increase was agreed before 22 April 2009.

Example C

Clive has been making contributions of £24,000pa to a personal pension via monthly instalments for the past two years. All of these contributions will be treated as normal regular pension savings.

For defined benefit schemes, such as the NHS Pension Scheme, all benefits earned will count as normal regular ongoing savings, providing the way in which the benefits are calculated does not change after 22 April 2009. Any increase in benefit as a result of a salary increase or the accrual of further pensionable service will be treated as normal regular pension savings.

The following example shows how the value of normal regular pension savings under a defined benefit scheme is calculated.

Example D

Mark's total taxable income exceeds £150,000. He is accruing officer benefits in the NHS Pension Scheme and has a personal pension.

On 6 April 2009, Mark has completed 10 years' pensionable service in the NHS Pension Scheme where pension benefits accrue on a 1/80th basis. His pensionable salary for that year is £80,000. His pension entitlement from the NHS Scheme on that date is £10,000pa. [10* 1/80 * £80,000 = £10,000pa]. His cash entitlement is £30,000. [10 * 3/80 * £80,000 = £30,000]

By 5 April 2010, Mark's pensionable salary had risen to £90,000.

His pension entitlement is £12,375pa [11 * 1/80 * £90,000 = £12,375pa] and his cash entitlement is £37,125.

Normal regular pension savings are determined as the increase in accrued benefit over the year. The increase in pension is £2,375pa and the increase in cash is £7,125.

To compare like with like, the increase in pension is converted into a lump sum by multiplying the increase in accrued pension by 10, as required by HM Revenue and Custom rules. That value is then added to the increase in the cash entitlement.

The value of Mark's normal regular pension savings from the NHS Pension Scheme is therefore £30,875. [£2,375 * 10 plus £7,125]

If, after 22 April 2009, there is a change to the rules that determine how the benefits in a defined benefit scheme are calculated, for example the rate of benefit accrual increases from 1/60th to 1/50ths, then the increase in benefit arising as a result of that change would not be treated as normal regular pension savings. Such an increase in pension savings would be liable to the special annual allowance charge providing the other criteria are met (which are that the individual has taxable income above £150,000 and makes total pension savings in the tax year in excess of £20,000).

The NHS Pension Scheme is about to start a choice exercise allowing members to move from the 1995 Section to the 2008 Section. Although accrual rates are higher in the 2008 Section, we understand that the Treasury have confirmed that this will not be caught by these measures.

Where a new arrangement (defined benefit or money purchase) is put in place on or after 22 April 2009, if the new arrangement is as a result of an individual changing employment and joining the new employer's existing arrangement, or is due to the current employer changing the pension provision for all its employees, then in most cases, the pension savings under the new arrangement will be treated as normal regular pension savings. However, the rules are complex in this area and individuals or employers likely to be in this situation should seek advice.

Do Additional Voluntary Contributions (“AVCs”) count as normal, regular pension savings?

Providing that the AVCs were being made at least quarterly to the AVC arrangement before 22 April 2009, and the level of these contributions doesn’t change after this date (or any change was agreed before 22 April 2009), these will count as normal regular pension savings.

Do contributions made towards buying NHS added years count as normal, regular pension savings?

Providing the arrangement to buy added years was in place before 22 April 2009 and the rate at which contributions are made doesn’t change, these contributions will be classed as normal, regular pension savings and therefore won’t be subject to the tax charge.

Individuals who have previously registered interest to buy added years, but who have not applied to do so by 22 April 2009, will be subject to the special annual allowance test in respect of added years purchased in the future as such added years will not be treated as normal regular pension savings.

Do contributions made towards buying NHS additional pension count as normal, regular pension savings?

Only if the arrangement was in place before 22 April 2009, and the contributions continue at the same level, will they count as normal regular pension savings.

Individuals who have previously bought additional pension and who choose to buy further additional pension, will not have that further additional pension count as normal regular pension savings.

What about redundancy arrangements?

It is not unusual to find that when employees are made redundant, they put any redundancy payment in excess of the £30,000 tax free threshold into the pension scheme. There are two points to note here. The first is that any redundancy payment in excess of the £30,000 counts as taxable income. This means that people earning much less than £150,000 may well be caught by the new tax charge if their redundancy payment is at such a level as to push their total taxable income for the year above the £150,000 limit. Any redundancy payment made into the scheme will also clearly not be normal regular pension saving. So it may be subject to the tax charge, depending on the amount of other pension savings the individual is making in the tax year.

Example E

Diane is in a 1/60th scheme and has a regular salary of £60,000 and expects to receive a lump sum Voluntary Redundancy (“VR”) payment of £135,000 on leaving her employer at the end of September 2009. The gross VR payment counts as taxable income. Because Jane’s total taxable income in the current tax year is likely to be above £150,000, she will be subject to the new tax charge if she makes a large pension AVC.

She can make a contribution, and will receive tax relief at the 40% rate when it is paid, but she will later be liable to pay the new 20% tax charge on part or all of the amount of the contribution, depending on the value of her regular pension benefit earned. If the value of her regular pension benefit exceeds £20,000, she will be subject to the new 20% tax charge on all of the contribution. If however, the value of her regular pension benefit is less than £20,000, she will only be subject to the new 20% tax charge on part of the contribution. This is because not all of her special annual allowance has been “used up” by her regular pension savings and so there is scope to make some additional non-regular pension savings before the allowance is breached and a tax charge is incurred.

She decides to pay an AVC to the pension scheme of £50,000 out of her VR payment to increase her pension. She receives the rest of her VR payment of £85,000 as a payment on leaving, and £30,000 of this is tax-free while the rest (£55,000) is taxed at 40%.

After the end of the tax year, she is liable for tax at the rate of 20% on her “excess” AVC contribution which is worked out as:

AVC contribution paid	£50,000
Value of final salary benefits earned*	£5,000
- Special allowance	-£20,000
Excess contribution	£35,000

She will therefore be liable for a payment of 20% of £35,000 = £7,000 after the end of the tax year (April 2010).

*calculated using HMRC’s formula as the value of 1/60th pension accrual for 6 months service in the tax year.

How will the new tax charge work?

Again note that although called a tax charge, this is really the clawback of tax relief.

The special annual allowance is calculated differently depending on whether or not an individual has made any contributions (or has had contributions made on their behalf) to a money purchase arrangement on a less frequent basis than quarterly. We will firstly look at the special annual allowance applying for members who have not made such contributions before considering the situation applying for those who have

<u>1. Individuals who have not made contributions to money purchase arrangements on a less frequent basis than quarterly</u>

If the value of the individual's normal, regular pension savings

- exceeds £20,000, the special annual allowance will be nil. In this case, any non-regular contributions will be subject to the 20% special annual allowance charge.

- is below £20,000, the special annual allowance will be greater than zero. In this case, any non-regular contributions in excess of the special annual allowance will be subject to the 20% special annual allowance charge.

Example F

Mark's total taxable income exceeds £150,000. He is accruing officer benefits in the NHS Pension Scheme.

On 6 April 2009, Mark has completed 10 years' pensionable service in the NHS Pension Scheme where benefits accrue on a 1/80th basis. His pensionable salary for that year is £80,000.

By 5 April 2010, Mark's pensionable salary had risen to £90,000.

The value of Mark's normal regular pension savings from the NHS Scheme is therefore £30,875 (see Example D)

As this is greater than £20,000, his special annual allowance is reduced to nil.

Mark also pays a one-off contribution in AVCs of £5,000. As there is no remaining special annual allowance, this one-off contribution of £5,000 will be subject to a 20% special annual allowance tax charge, which will be collected through the Self Assessment Tax Return.

In some cases, the £20,000 limit may provide some headroom to make additional contributions before 6 April 2011.

2. Individuals who have made contributions to a money purchase arrangement on a less frequent basis than quarterly

If the average of the contributions made less frequently than quarterly over the last three tax years (2006/07, 2007/08 and 2008/09) is less than £20,000, then the special annual allowance is calculated in the same way as for someone who hasn't made any infrequent contributions. In other words, their special annual allowance is calculated as set out above.

If however, the average of these infrequent contributions exceeds £20,000, the special annual allowance is calculated as follows:

If the value of the individual's normal, regular pension savings

- exceeds the lesser of £30,000 and the three year average of the infrequent money purchase contributions, the special annual allowance will be nil. In this case, any non-regular contributions (including the infrequent contributions should these continue) will be subject to the 20% special annual allowance charge.

- is below the lesser of £30,000 and the three year average of the infrequent money purchase contributions, the special annual allowance will be greater than zero. In this case, any non-regular contributions in excess of the special annual allowance (including some or all of the infrequent contributions should these continue) will be subject to the 20% special annual allowance charge.

In some cases, this limit (of the lesser of £30,000 and the three year average of the infrequent money purchase contributions) may provide some headroom to make additional contributions before 6 April 2011.

Example G

Emily's total taxable income exceeds £150,000. For the last three years she has been paying monthly contributions of £500 per month, and she has also made an annual contribution of £27,000 each year.

As the three year average of her infrequent money purchase contributions is £27,000, which is greater than £20,000 but less than £30,000, this will be the starting position for the special annual allowance. Her regular monthly contributions which equate to £6,000 per year will then serve to reduce this allowance so that her final special annual allowance is £21,000. This means that she can make non-regular contributions of £21,000 before being subject to a tax charge. Her non-regular savings for the year amount to £27,000 however. She will therefore be subject to a tax charge at the rate of 20% on the excess of £6,000. The tax charge will therefore be £1,200.

Example H

Frank's total taxable income exceeds £150,000. For the last three years, he has made an annual contribution of £65,000.

His special allowance will be capped at £30,000 (because the infrequent contributions exceed £30,000). He has no regular savings (payable less frequently than quarterly) which would serve to reduce this special annual allowance. As such, he will be subject to a tax charge on the difference between the infrequent contributions made of £65,000 and the special annual allowance of £30,000. He will therefore have to pay a tax charge of 20% of £35,000 = £7,000.

Example I

Sarah's total taxable income exceeds £150,000. She is accruing practitioner benefits in the NHS pension scheme.

Her total normal regular pension savings under the arrangements are calculated to be £17,400.

As her normal regular savings do not exceed £20,000, she still has some special annual allowance remaining. This is calculated as £2,600. [£20,000 less £17,400].

Sarah could therefore make a one-off contribution of up to £2,600 and not be subject to the special annual allowance tax charge.

What can be done if an individual makes a contribution which is subject to the tax charge, but then later wishes he/she hadn't made the contribution?

In this situation, the individual would be allowed to seek a refund of any excess contributions paid after 22 April 2009 and it may be granted, provided certain conditions are met. Payment of the refund would also only be possible if the rules of the specific pension scheme allowed such a refund. The refund cannot be made until after the end of the tax year in which the contribution was paid, and would be subject to tax at the rate of 40% (in other words the tax relief previously enjoyed would be recouped). Any individuals likely to be in this situation are advised to seek advice.

Do the new charges apply to individuals with Enhanced Protection?

Yes, affected individuals will still be subject to the special annual allowance charge, even if they have Enhanced Protection.

How does the special annual allowance interact with the existing annual allowance?

The new special annual allowance runs alongside the existing annual allowance. Just as a recap, the annual allowance is the amount of pension savings an individual can make in any one year without being subject to a tax charge. Any pension savings made in excess of the annual allowance are subject to tax – or more properly do not get tax relief. For individuals liable to tax under both allowances, the special annual allowance charge will be reduced by the excess over the annual allowance to ensure that tax relief is not recovered twice.

The new measures sit alongside the lifetime allowance which is not affected by these changes.

Does the special annual allowance charge apply in the year of becoming entitled to benefits?

Where all benefits are taken under an arrangement, there will be a test against the special annual allowance except where either :

- The arrangement is a defined benefit (or final salary) arrangement and at the time the benefits are taken, there are at least 20 members in the scheme. In addition, the taking of the benefits is not part of a scheme or arrangement, the main purpose (or one of the main purposes) of which is to avoid the special annual allowance charge; or:

- the benefits are being paid because the individual meets the ill-health condition and the arrangement is either an occupational scheme, public service scheme or group personal pension scheme.

What should an individual do if they believe they will be affected by the proposed legislation?

Anyone who believes they are likely to be affected by the proposed legislation because they meet the necessary criteria (see the section entitled “who is affected by the measures?”) is advised to seek independent financial advice.