Punter Southall GROUP

High Earners & Contributors: Survival Guide

Briefing notes for companies and trustees

October 2010

Annual allowance approach confirmed

On 14 October, Mark Hoban, the Financial Secretary to the Treasury, confirmed the Government's approach to restricting pensions tax relief. As expected, it will scrap the previous Government's complicated proposals for a high income excess relief charge and replace them with a reduced annual allowance aimed at raising the same overall tax yield.

The annual allowance

It has now been confirmed that the annual allowance will be set at £50,000. This is higher than had been expected given that HM Treasury had previously been considering a figure in the range £30,000 to £45,000. This compares with the current figure of £255,000. The figure of £50,000 will be fixed over the forecast period to 2015/16; beyond that date, the Government will consider options for indexing the level of the annual allowance.

A single flat factor of 16 will be used to value the annual increase in defined benefit, i.e. a £1 increase in annual pension is valued at £16. This is at the lower end of the 15-20 range that the Government had considered.

The Government has also announced a number of other measures that will reduce the number of people on more moderate incomes who will find themselves liable to a tax charge under a reduced annual allowance:

- Deferred pensions will not be tested against the annual allowance, where the pension is revalued in line with CPI or a rate specified in existing pre-14 October scheme rules.
- For active members of defined benefit schemes, only annual increases which are in excess of CPI will be tested against the annual allowance.
- Individuals will be able to carry forward any unused annual allowance from the previous three years in order to reduce their liability to the tax. This is likely to be of particular benefit where an individual has a one-off spike in their pension benefits, for example because of a significant promotional salary increase. In many cases, the carry-forward facility will mean that individuals who would otherwise have faced a large tax charge will see their tax liability reduced to nil.
- Where individuals take early retirement, there will be no adjustment to the flat factor of 16 to take account of the fact that the pension is being paid from an earlier age (although exceptional increases will be covered by anti-avoidance legislation).
- There will be no test against the annual allowance on death or serious ill-health (i.e. terminal illness). The Government is also considering additional measures to exempt other pensions payable on ill-health. However, there will still be a test against the annual allowance on redundancy.

In broad terms, the design of the reduced annual allowance is more generous than had been expected from the July consultation with a higher annual allowance and lower flat factor as well as the availability of a 'carry-forward' mechanism. The Government now estimates that only 100,000 people will be affected by the reduced annual allowance, of whom 80% will have an income in excess of £100,000.

The lifetime allowance

The news on the lifetime allowance is not so good – and, to some extent, the relative generosity in the terms of the annual allowance is achieved by a restriction in respect of the lifetime allowance, which will be reduced to £1.5 million (expected to be with effect from April 2012).

The Government has confirmed that existing protections of benefits in excess of the lifetime allowance under primary and enhanced protection will not be affected. So, for example, where individuals are protecting a percentage (such as 120%) of the lifetime allowance under primary protection, that percentage will have to be reviewed so that the level of protection is not reduced. Whilst it will come as a relief that existing primary and enhanced protections will be preserved, individuals with enhanced protection will now become subject to the annual allowance for the first time.

In addition, the Government is considering additional protections for individuals with benefits in excess of £1.5 million or those who were targeting a lifetime allowance of £1.8 million. This could involve adding two new protection regimes – for those with benefits already in excess of £1.5 million and for those who opt for a fixed lifetime allowance of £1.8 million in return for agreeing to cease contributions or accrual in their pension schemes.

Anyone who is familiar with the complexities of the existing primary and enhanced protection regimes will not relish having to get to grips with two additional kinds of transitional protection. The Government has indicated that it would welcome representations on these issues by 29 October 2010 and it plans to introduce draft legislation on the lifetime allowance issues by the end of the year.

It has also been confirmed that the rules on EFRBS will be changed to make them less attractive than other forms of remuneration, which is likely to rule them out in future as possible top-up arrangements for income in retirement.

Administration consequences

The changes announced on 14 October are likely to have a number of implications for the administration of pension schemes:

- There will be a new information requirement that pension schemes must provide members with details of their pension input amount (the amount of contributions or increase in pension earned over the year) within six months of the end of the tax year, where the individual has a pension input amount within that scheme in excess of the annual allowance. Schemes will also need to provide information on the annual allowance for the three previous years to ensure that these members can take advantage of any 'carry-forward' headroom.
- In addition, schemes will have to provide this information to any member who requests it. This will include members who have benefits in more than one scheme whose benefits when taken together exceed the annual allowance. In these cases, schemes will have until the later of six months after the end of the tax year and three months from the request to provide the information. In practice, however, we expect that many individuals will ask for information to be provided more quickly as they come up against the deadline for submitting their tax return and realise that they need pensions information to complete their form.
- Employers will have to provide information to pension schemes on pensionable pay and service within three months of the end of the tax year.
- Both schemes and employers will be given a year's grace to comply with these new information requirements. If the information is not available in time for members to complete their self-assessment form, members will have to estimate a value with an adjustment being made to their tax position when the employer and/or scheme finally provide accurate information. Whilst this appears to be a useful concession, it will not necessarily help scheme administrators. Members are still likely to contact schemes to ask for this information even if schemes are not legally obliged to provide it.
- The Government has decided not to align the 'pension input period' (over which benefits are calculated for the purpose of testing against the annual allowance) with the tax year. Many schemes currently look at benefits over their scheme year, rather than over the tax year. An alignment with the tax year would have concentrated activity in the third party administration sector around the already busy tax year end, so administrators are breathing a sigh of relief that schemes will not have to adjust their existing pension input periods.
- However, this gives rise to some transitional measures for schemes whose pension input periods for the 2011/12 tax year had already started by 14 October 2010, which will give rise to some complicated calculations, particularly where members also wish to take advantage of the carry-forward provisions.
- One consequence that administrators have particularly dreaded is what is known as 'scheme pays', a mechanism under which members facing an unaffordable tax charge can ask the scheme to pay the tax charge with a consequent reduction in their pension benefits. The Government acknowledges that this could place a significant burden on schemes and is therefore planning to consult on the best way to balance affordability for individuals, the requirements of the exchequer and the administrative burden on schemes.

Next steps

Whilst many of the details are now confirmed, we still do not have a complete picture and, in particular, are waiting for more details on the proposals for the lifetime allowance and on the new information requirements. More details will become available over the next few months:

- In November, the Government will consult on the options as to how members can pay significant tax charges (with draft legislation expected in February).
- In late 2010, draft clauses for the Finance Bill 2011 will be published covering further exemptions from the annual allowance for ill-health early retirement, the reduction in the lifetime allowance, possible forms of additional protection and changes to EFRBS.
- In early 2011, we are expecting draft regulations on the information requirements for schemes and employers.

Employers and individuals cannot, however, wait to take action – employers will need to identify which of their employees are likely to be affected by the annual allowance in this particular shape and decide whether any changes to scheme design are necessary to minimise the risk of exceeding the annual allowance. They are also likely to want to identify any individuals who may be affected by the reduction in the lifetime allowance.

Individuals should consider how an annual allowance of £50,000 would affect them, and in particular whether they have any headroom from previous years' pension scheme membership to carry forward. HM Revenue and Customs have produced draft guidance to assist them.

Where can I get further information?

For further information, please get in touch with Jane Beverley on 020 7839 8600 or by email to jane.beverley@puntersouthall.com or discuss with your usual Punter Southall contact.

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