Punter Southall GROUP

High Earners & Contributors: Survival Guide

Briefing notes for companies and trustees

August 2010

HM Treasury consults on alternative approach

In the third of our series of Survival Guides, we focus on a discussion document published on 27 July by HM Treasury that sets out some of the key questions to be answered in using a reduced annual allowance approach to restrict pensions tax relief. The consultation (which closes on 27 August 2010) gives some indication of the direction of the Government's thinking; however, with less than nine months until the new arrangements take effect, there are still no firm conclusions.

The annual allowance

The Government is of the view that flat factors should be used to value the increase in the growth of defined benefit pension benefits over the year. This is similar to the current approach, which uses a factor of 10:1, i.e. £1 of annual pension is valued at £10. Provisional analysis from the Government Actuary's Department suggests that a factor in the range 15-20:1 may be appropriate, and that using a factor in this range means that an annual allowance of around £40,000 might be sufficient to deliver the required tax revenue.

The Government also proposes to change the current annual allowance charge from 40% to a tailored charge that would have the effect of removing all tax relief on contributions (including the value of employer-sponsored benefits) in excess of the annual allowance, irrespective of an individual's income.

A further possible change to the current form of the annual allowance is that, when calculating the increase in the accrued benefit, only the increase over and above the cost of living will be considered. In addition, deferred members could be exempted completely.

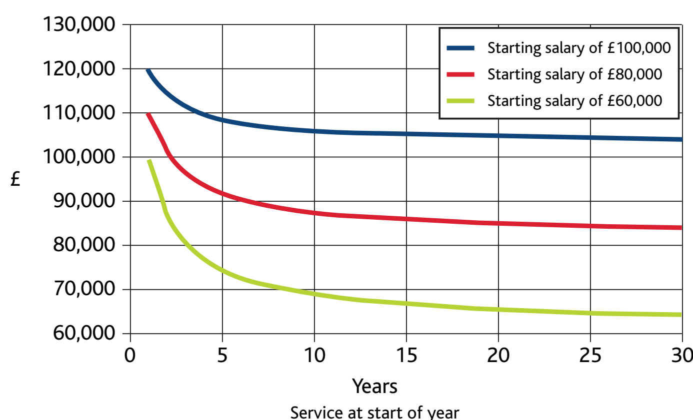
The Government is also proposing exemptions in cases of death or serious ill-health. However, the current exemption from the annual allowance in the year of retirement would be removed and there would be no special treatment for redundancy or ill-health early retirement.

Implications of the proposed approach

The use of a higher flat factor means that some individuals may well face a higher tax charge than they would have done with an annual allowance of £30,000 but with a 10:1 factor.

The graph below takes an individual on a salary of £60,000, £80,000 or £100,000 at the start of the year and shows how the salary they would need to have at the end of the year for them to be liable to the tax charge changes based on their past service.

This assumes inflation protection of 3%, an annual allowance of £40,000 and a flat valuation factor of 17.5:1. The accrual rate is 60ths.



We can see the impact of the new proposals on a particular individual on this level of income by revisiting one of the examples from our previous Survival Guide.

Example: Mike

Mike has an income of £80,000 in 2010/11 but receives a promotion in 2011/12 taking his income to £100,000. By the end of the 2011/12 tax year, he will have accrued 16 years service in his defined benefit scheme.

With the annual allowance set at £30,000 and benefit increases in excess of that taxed at 40%, a flat factor of 10:1 and no exemption for inflation increases, he would have faced a tax charge of nearly £15,000.

Under the approach proposed in the latest consultation, even assuming that Mike still pays only 40% tax on benefit increases in excess of the annual allowance, the amount of the tax charge would increase. With an annual allowance set at £40,000, a flat factor of 17.5:1 and an allowance for inflation increases of 3%, he would be looking at a tax charge of around £26,500. If any of his benefits were taxed at 50% rather than 40%, this would increase further.

The Government's proposed use of higher flat factors therefore makes the situation even worse for 'hard cases' like Mike. This is a problem recognised in the consultation paper. The Government proposes to address this both by supporting employers in making changes to their pension schemes, and by enabling individuals to deal with unaffordable high charges when they arise.

One of the key approaches that the Government thinks employers might take is capping or phasing in annual pensionable pay increases, so that salary increases each year do not take the individual over the annual allowance.

The Government also suggests that employers may remove benefits which are likely to give rise to such spikes in accrual such as enhanced early retirement, ill-health service enhancements or top-ups on redundancy.

Where individuals find themselves faced with high charges which they cannot pay, the Government is considering a range of approaches including:

- allowing individuals to spread payment of the charge over several years;
- enabling schemes to pay the charge with benefits being reduced accordingly – the 'scheme pays' option;
- allowing individuals to 'unwind' pension savings in excess of the annual allowance – this should be simpler than 'scheme pays' as the scheme would simply be reducing benefits in order to refund money to the individual and/or employer, and would not need to liaise with HM Revenue and Customs (HMRC) to pay the tax.

The level of tax relief

The Government is also considering whether pensions tax relief should be capped at 40% (not 50%). This could allow the annual allowance to be set at a higher level, but would considerably complicate the system of tax relief, as it would reintroduce many of the complexities of the 'high income excess relief charge' proposed by the previous Government.

Pension input periods

The consultation also considers whether the period over which benefits are assessed (the 'pension input period') should be aligned with the tax year. If this change is not made, some individuals will already be accruing benefits in a pension input period which will be assessed in the 2011/12 tax year and so will be subject to the reduced annual allowance. The Government is therefore considering introducing transitional provisions.

The level of the lifetime allowance

The announcement published on the day of the Emergency Budget hinted that changes might also be required to the lifetime allowance. The latest discussion document confirms that the Government is still thinking along these lines. It floats the idea of reducing the lifetime allowance from its current level of £1.8 million, possibly to £1.5 million, and considers whether the 20:1 factor for valuing defined benefits for lifetime allowance purposes should be changed (it does not specify what level of factor is being considered).

Protection for existing benefits

If the Government does reduce the lifetime allowance, it has said that it would provide protection to individuals with savings above that level. However, it is also considering freezing existing primary and enhanced protection amounts from the date the changes are introduced, so that any further increase in benefits would become subject to the lifetime allowance charge.

In addition, the Government intends to remove the exemption from the annual allowance charge for individuals with enhanced protection. The combination of these changes could lead to a massive undermining of the value of enhanced protection for individuals who had previously been expecting to pay no tax on their pension benefits at all.

Example: Vicky

Vicky has enhanced protection on her defined benefit pension. If enhanced protection were no longer to provide an exemption from the annual allowance, she could potentially face a tax charge of £50 on each extra £100 of pension growth in excess of the annual allowance, which would need to be paid immediately via self assessment out of her net pay.

In addition, the freeze in the enhanced protection level would mean that the increase in Vicky's benefits would not be protected from tax at retirement, so it would be subject to the lifetime allowance charge (currently at a rate of 55%). In other words, Vicky would be facing a total effective tax rate of 105% on accrual above the annual allowance, meaning the additional accrual would actually leave her worse off.

Provision of information

The discussion document also contains proposals on the information to be provided by schemes. In particular, it asks for views on whether schemes should be required to:

- provide details of the pension input amount to members who request it;
- inform members when they have exceeded the annual allowance; and
- report to HMRC where members exceed a set limit.

Next steps

The consultation closes on 27 August 2010 and the Government will then confirm its intended approach by the end of September, with draft legislation expected in the 'autumn'. Assuming that the alternative approach is adopted, it will come into effect on 6 April 2011 and be legislated for in the Finance Bill 2011. Any options to support individuals in paying the tax charge (such as spreading the charge or unwinding accrual) will be deferred to the Finance Bill 2012.

This all makes for a very tight timescale, especially if employers are intending to make changes to their scheme such as changing the definition of pensionable pay. Any change would be subject to the usual 60 day consultation period, so careful planning will be needed to implement the change before 6 April 2011.

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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