Quattro Pensions
consulting actuaries

Pensions Bulletin October 2010

Pensions tax relief - changes announced

HM Treasury announced last week the main changes that are to be made regarding tax relief for pension scheme contributions and benefits.

In brief, these are that:

- The Annual Allowance will be reduced from £255,000 to £50,000 from April 2011.
- The Lifetime Allowance (used to test the overall level of benefits at, for example, retirement) will be reduced from £1.8m to £1.5m from April 2012.

In this bulletin we give some more information and examples on yesterday's announcement. However some of the detail regarding the transitional arrangements is still to be decided – we will cover these issues in a further bulletin once the Government has decided on its approach.

How does the Annual Allowance work?

The Annual Allowance sets a limit for the amount by which pension rights can increase in any one year without attracting tax charges. Where the annual allowance is exceeded, tax will be payable on the excess above the allowance at the individual's marginal rate.

For a defined contribution scheme, the Annual Allowance is compared to the total contribution made to the Scheme from both employer and employee during the year. Growth in an individual's pension pot because of investment returns is not taken into account.

For a defined benefit scheme a different approach is used. Here a value is assigned to the increase in accrued pension over the year that is over and above any increase due to inflation. Former members of a scheme are exempt from the Annual Allowance test in respect of their deferred benefits. For active members, salary increases above the rate of inflation and additional accrual will both affect the calculation. A detailed example is given later in this bulletin for those who are interested.

Some further points from yesterday's announcement

The main details that we do have from yesterday's announcement are as follows:

- There are no plans to index the Annual Allowance for at least 5 years so it will remain at £50,000 during this period.

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- Deemed contributions to defined benefit schemes will be calculated using a flat factor of 16 rather than 10 as previously. This change will mean that it is more likely that an individual's increase in pension in any year will exceed the cap. (An example of how the increase in benefit is calculated is given later in this bulletin. For testing the Lifetime Allowance a factor of 20 will continue to be used (although this may be reviewed at some stage).

- It will be possible to carry forward unused Annual Allowance from the previous 3 years in assessing whether the Allowance is breached in any year. This is designed to help with those cases where there is a special increase in pension during a year because of, for example, a large promotional payrise. For the 3 years to April 2011, the Allowance will be restricted to £50,000 in line with the new regime rather than the higher figures that actually applied for the purpose of calculating any carry forward.

- There will be exemptions where large payments are made in a particular year in special circumstances such as serious ill health or in the year of death. The position regarding other ill health retirements is still under consideration.

- There will be no exemption for special payments occurring because of redundancy.

- The existing exemption whereby there is no restriction on the amount that can be paid in to the scheme during the year in which retirement actually takes place is to be removed (other than as mentioned above).

- There will be no exemption for anyone claiming "enhanced protection".

- Where the annual allowance is exceeded, tax will be payable at the individual's marginal rate. The Government is consulting on whether to introduce measures such that the tax charge can be paid from the pension benefit rather than income to help those individuals where a higher tax burden from income may be unmanageable.

- The Government intends to bring forward measures to prevent "avoidance" in relation to the new measures.

- As far as the Lifetime Allowance is concerned, the Government is still consulting on what would be a fair way forward for people who already have or are already targeting benefits based on a figure of £1.8m rather than the new figure of £1.5m.

Who will be affected?

The Government expects that the changes to the Annual Allowance will affect around 100,000 people. Of these 80% will earn over £100,000.

It will be easy for those in a defined contribution scheme to see each year whether the contributions are likely to exceed the limit.

For those in defined benefit schemes, the situation is less straightforward. The annual allowance will be breached where the increase in benefit (above inflation) over the year exceeds £3,125 (ie £50,000/16).

Example

The following example illustrates the method:

Suppose we have a member with a pensionable salary of £60,000 and 30 years' pensionable service at the start of the year.

In a 60ths scheme, the accrued pension at the start of the year for this member is

30 x 60,000 / 60 = £30,000

If inflation is 2% over the year then we can revalue this to £30,600 (£30,000 plus 2%) before we need to take any increase into account for Annual Allowance purposes.

If the member actually has a 10% payrise over the year then the accrued benefit at the end of the year will be:

31 x 66,000 / 60 = £34,100

So the pension increase for annual allowance purposes is £3,500 (ie £34,100 - £30,600) and the deemed contribution is £56,000 (ie 3,500 x 16).

If the member had no unused allowance from previous years then tax would be payable on £6,000, the amount above the Annual Allowance limit of £50,000, at the individual's marginal rate.

So how can you gauge whether you are likely to be affected?

A breach can arise where some or all of the following apply:

- the scheme accrual rate is high (eg in a 30ths scheme, or where a member is earning a 2/3 pension over a relatively short period)
- an individual's pensionable salary is high
- an individual has a large payrise in excess of inflation (particularly if combined with substantial pensionable service).

In practice, where an individual has (deemed) contributions over the Annual Allowance, the scheme will provide the member with the pension input amount within 6 months of the end of the tax year.

However if you are concerned that you or members of your scheme are in this category you may wish to take advice now.

Please contact your Quattro Pensions contact to discuss this issue further if you would like further information.