



## Changes to tax relief on pension contributions

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**Making pension contributions remains a highly tax-efficient way to save for retirement but, for some individuals with high annual incomes, the tax relief available is reduced for 2009/10 onwards.**

The Government's stated reason for introducing new pension rules is to limit the cost to the UK of tax relief given to high income individuals from 2011/12 onwards and, despite the change of Government, this remains the objective. In advance of the change, 'anti-forestalling' rules were introduced from 22 April 2009 to prevent such individuals benefiting from making substantial increases in their pension provision in 2009/10 and 2010/11. These anti-forestalling rules were extended from 9 December 2009.

In practice, the anti-forestalling rules work by allowing individuals to claim full tax relief on their own contributions and then by clawing back relief on the same contributions to restrict it to 20%. Unfortunately, the clawback Special Annual Allowance Charge (SAAC) applies to all contributions made by **or for** an individual in a year. So, even if an individual falling within the rules does not make personal contributions on which tax relief could be claimed, if his or her employer does make increased contributions, any clawback SAAC will be levied on the individual.

### Who is affected by the transitional rules?

From 22 April 2009 to 8 December 2009, only individuals with annual 'relevant' income in excess of £150,000 in a tax year (or either of the prior two tax years) were subject to a clawback SAAC. However, from 9 December 2009, this threshold fell to £130,000

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of annual relevant income – although slightly different criteria operate for those earning between £130,000 and £149,999 when calculating relevant income (see below). For this purpose, an individual's total relevant income includes all interest, dividends, and trading income as well as earnings from employment. In many circumstances, this may make it difficult for employers to assess whether or not a proposed pension payment will trigger a SAAC for an individual. In addition, no matter how large an individual's pension contributions are in a year, his or her total relevant income for the purpose of the threshold test is only reduced by a maximum of £20,000 of pension contributions.

#### ■ Example – Mr Smith.

Mr Smith has total gross income for 2010/11 of £175,000. He makes regular ongoing contributions to a personal pension of £50,000 each year by monthly payments.

- For income tax purposes his taxable income is effectively £125,000 (£175,000 less £50,000).
- However, for the purpose of the SAAC calculation his total income is £155,000 (£175,000 less £20,000).

Further anti-avoidance provisions negate the tax advantage of salary sacrifice arrangements designed to reduce an individual's total income – the amount

sacrificed is effectively added back for the purposes of the threshold test. Other arrangements entered into simply to trigger a tax advantage are also blocked by a general anti-avoidance provision.

### Normal pension savings

As these rules are only intended to block any forestalling action taken by high income individuals, those that simply continue with the normal on-going pattern of their pension savings established in past years should not be affected provided that such payments are made on a quarterly or more frequent basis. Such ongoing payments are effectively 'protected' from the clawback charge.

- So, in our example, Mr Smith would not face a charge as he is just continuing his established payment pattern.

Amendments to the rules introduced in March 2010, but taking effect from 22 April 2009, confirm that it is possible to switch pension providers (as long as there is no more than a three month gap in contributions) and continue to make protected contributions. Provided there is no change in the level of cash contributions (or a material change in the pension rights) the continuing contributions are protected from the clawback charge. These rules can also apply to defined benefit, cash balance or AVC schemes in some situations where a business is taken over and employees join the new employer's scheme or where an employer decides to operate its occupational scheme through a new provider.

The charge applies where the total contributions made by or for an individual in 2009/10 or 2010/11 exceed the normal ongoing pattern of pension savings or the Special Annual Allowance (SAA), whichever is the greater.

- If Mr Smith's employer was to make a contribution of £100,000 to a money purchase pension on his behalf in 2010/11, Mr Smith would be liable to a 30% SAAC amounting to £30,000.

After the April 2009 announcement, there was much debate over how regular contributions have to be treated as protected contributions. Following representations made during the committee stages of Finance Act 2009's progress through Parliament, the Government added further rules that apply where

lump sum contributions have been made in past years. Where any payments were made in 2009/10 (after 22 April 2009) or 2010/11, there will be clawback charges if the payments in a tax year exceed the higher of:

- £20,000, or
- the average of lump sum contributions made per year in the three tax years up to April 2009 (subject to a maximum of £30,000).

For example, if Mrs Jones had made lump sum payments averaging £50,000 in the three years to 5 April 2009 (and no other contributions are made by or for her), making a similar payment after 22 April 2009 in the 2009/10 tax year would have triggered a clawback charge of £4,000 ((£50,000 - £30,000) x 20%).

Where both frequent payments (quarterly or monthly) and infrequent (lump sum) payments were made in the three years to 5 April 2009, the position is more complicated and you should seek professional advice on what payments can be made without triggering a clawback charge.

### Restrictions from 9 December 2009

It was announced in the 2009 Pre-Budget Report that the anti-forestalling rules also apply to individuals with relevant income of less than £150,000 but at least £130,000 with effect from 9 December 2009. The rules apply to those persons in the same way as they apply to individuals with income of at least £150,000 except that references to 22 April 2009 are replaced with references to 9 December 2009. For example, for an individual with relevant income of £140,000, pension contributions made during the 2009/10 tax year but before the new rules took effect (on 9 December 2009) will be ignored.

Increases in pension savings over and above an individual's normal regular pension savings made on or after 9 December 2009 are subject to a SAAC. For example, if an individual with income of £140,000 in 2009/10 made a first ever payment to a pension scheme in the sum of £38,000 in September 2009, there is no clawback charge. However, if the payment had been made on 10 December 2009, a clawback charge of £3,600 would arise.

## Defined benefit / final salary schemes

Employer contributions to defined benefit (final salary) schemes need to be taken into account and can trigger a SAAC.

Since April 2006, employees' entitlements under such schemes have been valued to calculate a deemed annual contribution amount that can be compared with the overall annual contribution limits. Where the deemed contribution exceeds the limit, tax is levied at 40% on individuals on the benefit in kind of any excess under the existing rules.

Now the same valuing methodology is used to assess whether or not the SAAC will apply. However, if there have been no 'material changes' in the pension entitlement of an individual (for example, a material change could include a switch from a 30/50<sup>th</sup>s scheme to a 40/60<sup>th</sup>s scheme) a transitional charge should not arise on that individual. If there has been a material change, the transitional 20% charge will apply up to the annual contribution limit, with the existing 40% charge applying to deemed contributions above the annual contribution limit.

## 2010/11 tax year

The new additional rate of income tax applies at 50% for individuals with annual taxable income in excess of £150,000 for 2010/11. It should be noted that where individuals with a total annual income in excess of £150,000 make contributions in 2010/11 that are protected from a clawback charge, tax relief is expected to be available at 50% on some or all of the payment.

However, the SAAC for 2010/11 is applied at a rate which ensures that tax relief is effectively restricted to the basic rate of income tax on pension contributions in excess of the SAA. For example, where tax relief at 50% is given on contributions that are not protected, the clawback charge will be at 30% to ensure that only 20% net tax relief is obtained overall.

It is important to remember that with the SAAC threshold at £130,000 and the various add back rules and limits on reductions to relevant income, many individuals will become liable to the SAAC even though they fall short of becoming 50% taxpayers in 2010/11.

## Other changes in 2010/11

When a registered pension scheme repays tax-relieved pension contributions to a member who has completed less than two years service, tax is deducted by the scheme provider from the amount repaid. The rate of the charge is currently 20% on the first £10,800 refunded and 40% on any excess. With effect from 6 April 2010, these charges increased to 20% on the first £20,000 and 50% on any excess.

In addition, a change to the rate of tax payable in some situations on benefits paid out of an employer-financed retirement benefit scheme (EFRBS) has applied since 6 April 2010. Where benefits are paid on or after 6 April 2010 to someone other than an individual (such as a pension scheme), a 50% tax charge will apply. This measure prevents arrangements under which benefits are paid through an EFRBS to another person or entity in order to avoid the 50% income tax rate which took effect from 6 April 2010, or where an EFRBS is used to avoid exposure to the SAAC.

## Restriction of tax relief from April 2011

Finance Act 2010 (which was given Royal Assent on 8 April 2010) contains a set of rules designed by the former Labour Government to restrict pensions tax relief for individuals with relevant income of £150,000 or more from 6 April 2011. However, in the interests of simplification and to preserve revenue, the new coalition Government intends to repeal those complex provisions and replace them with more straightforward rules: the Government has set itself a deadline of 31 December 2010 for achieving this. The SAAC for 2009/10 and 2010/11 will not change.

The Government's July 2010 discussion document on potential new ways to restrict pensions tax relief suggests that reducing the annual limit for qualifying contributions made by individuals and companies would be the most straightforward option. It envisages reducing the allowance from the current £255,000 to somewhere between £30,000 and £45,000 (a limit of £40,000 is expected to raise the level of revenue to meet the Treasury's target) and remove some of the current exemptions from the allowance. The document also suggests that income tax relief on contributions would be restricted to a maximum of

40% to ensure that 50% taxpayers do not receive 50% relief on any of their contributions.

Addressing the lifetime allowance for the value of an individual's fund, the document contemplates reducing it from £1.8m currently, to £1.5m. Further, the growth beyond the lifetime allowance limit of funds with 'primary' or 'enhanced' protection may be taxed when benefits are taken after 6 April 2011.

The Government is also considering increasing the factors used to calculate the input value (deemed employer contribution) and the lifetime allowance value for defined benefit schemes.

If the annual contributions limit is reduced to a fifth of its current level, for some individuals, there could be a significant advantage in maximising contributions in the current tax year – even where such contributions trigger a SAAC under the current transitional rules. For example, a self-employed individual with relevant earnings of £250,000 for 2010/11 could make a personal pension contribution of £200,000 net and, with 20% tax relief, increase his or her pension pot by £250,000. Although any higher rate tax relief on the contribution is balanced by the SAAC, a tax subsidy of £50,000 would still go into the individual's pension fund.

For an employed individual whose employer makes a large pension contribution, the SAAC (at up to 30% of the contribution) creates a real cash flow cost for the employee as the employee will, in effect, have to repay the excess tax relief given at source. In some circumstances, for example where the individual concerned is nearing retirement, it may be worthwhile

for the employee to accept this cost on the basis that his or her pension fund can be increased significantly this year – by up to £255,000 (or 100% of net relevant earnings, if lower) – without incurring the penalty tax charge of 40% that may arise on a similar contribution in 2011/12 if the annual contributions limit is reduced to £40,000. In many cases, the ability of the employee to take up to 25% of the pension fund as a tax-free lump sum will improve the net tax position where retirement is expected in the near future.

The suggested changes raise a number of practical problems for individuals and employers and it is hoped that they can be addressed before the detailed proposals are published (by the end of September 2010). Clearly, both employers and employees will need to take specific advice on maximising the individual's pension fund and minimising tax charges at that stage. In any case, you should always consult an independent financial adviser before taking any decisions concerning your investments or pensions, and tax concerns must be balanced against your investment priorities. PKF Financial Planning Limited would be pleased to help; please get in touch through your usual PKF contact.

### **Acting now**

Continuing established pension savings at the same quarterly or monthly rate established before April 2009 should not trigger tax problems under the transitional rules in 2010/11. However, unless there is an overriding investment or practical reason for new or one-off pension contributions to be paid by or for high income individuals, it would be sensible for such contributions to be deferred until professional advice on the tax consequences can be obtained.

**Please get in touch with your usual PKF contact to arrange a joint meeting with a tax expert and an IFA from PKF Financial Planning Limited to discuss your options.**

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