

## Proposals for restricting pensions tax relief

### Impact on high earners in defined benefit arrangements

In December 2009, the Government published a consultation on the implementation of its proposals to restrict pension tax relief for high earners from 6 April 2011. In March 2010, the Government confirmed that they plan to proceed largely along the lines set out in the consultation. A summary of the proposals is set out in Table 1.

The proposals include a method for valuing the “deemed contribution” in respect of an individual earning a defined benefit (as opposed to the actual contribution to a defined contribution arrangement). This deemed contribution will be used to assess whether an individual’s total income exceeds the threshold of £150,000 for restriction of tax relief as well as being the basis on which any restriction in relief will be calculated.

We await final details of the new regime and there is still uncertainty in some areas. Nonetheless, it seems that the regime will be complex with numerous implications for defined benefit pension schemes and their members. In particular, the proposed method for valuing defined benefit pension accrual could have a significant impact on the finances of affected members – broadly speaking, those with total income exceeding £130,000. Any affected member should consider reviewing their position (in conjunction with their employer) and take any necessary action in advance of the changes coming into force, particularly where there are plans to draw benefits shortly after 6 April 2011.

In short, decisions and actions being taken now may already be having an impact on an individual’s tax liability under the new regime.

#### Questions that might need to be considered include the following:

##### **Is pre-tax income likely to exceed £130,000?**

All income is included for this purpose, not just salary. This means that any bonuses, overtime and non-pensionable pay are included as well as interest on bank deposits and rent on properties.

It may be desirable to spread bonuses over a number of tax-years, if this keeps pre-tax income below £130,000. Similarly, it may be worthwhile reorganising investments if this avoids the threshold being breached.

The Government is proposing that the income test be based on the higher of income in the current and previous tax-year for any year in which benefits are drawn in full from a particular arrangement. Therefore, income during the 2010/2011 tax-year may be relevant for those planning to retire after 6 April 2011.

##### **If pre-tax income does not exceed £130,000 now, is it likely to do so in future?**

The proposals could lead to extraordinary marginal tax rates where an individual crosses the threshold; potentially far exceeding the additional income that has caused the threshold to be breached.

##### **Is a promotional salary increase likely to lead to a large increase in defined benefit pension after 2011?**

Where this occurs, it is proposed that the deemed contribution will take account of the resulting increase in the entire accrued pension and not just the pension accrued in the year the increase is awarded. It may be possible to agree to spread pensionable salary increases in these circumstances.

##### **Are there any plans to take early retirement after 6 April 2011?**

There is potential for enhanced early retirement packages to result in large tax charges under the proposals. Indeed, any early retirement could lead to tax charges if the early retirement terms are not cost-neutral compared with the factors adopted by HMRC for valuing pension accrual.

Although there are other factors to consider, it may be worthwhile bringing forward early retirement plans in advance of 6 April 2011 in some circumstances.

##### **Does continued pension accrual for high-earners make sense given the tax position?**

If not, it may be necessary to agree alternative compensation in advance of the changes coming into force.

## Table 1: Summary of current proposals

How is pension tax relief changing?	Pension tax relief will be restricted for “high earners”, which in broad terms means those with income in excess of £130,000 per annum.
When are the changes going to happen?	The proposals are due to come into force from 6 April 2011.
Exactly who is affected?	Anyone with pre-tax income in excess of £130,000 per annum is potentially affected by the changes.  For this purpose, pre-tax income includes all sources of taxable income (e.g. interest on bank deposits or rental income) as well as an individual’s own pension contributions and charitable donations.
What about employer pension contributions?	If pre-tax income is in excess of £130,000, then the individual falls within the ambit of the new regime and the value of pension contributions funded (or eventually funded) by the employer needs to be determined.  Pension tax relief is then restricted if the total income, including the value of employer pension contributions, exceeds £150,000.
How is tax relief restricted?	To avoid a “cliff edge” for affected individuals when income exceeds £150,000, tax relief on pension contributions will taper from 50% where total income is £150,000 down to 20% where total income is £180,000 or more.
What about “defined benefit” schemes, where the pension is defined at retirement and there is no identifiable pension contribution for an individual in any tax year?	The Government intends to calculate the “deemed contribution” to a defined benefit pension arrangement – i.e. the value of pension earned during a year – using age related factors recommended by the Government Actuary’s Department.  This deemed contribution will be used to determine whether the £150,000 income threshold is breached as well as the pension contribution on which tax relief should be restricted.
How will the restriction be applied in practice?	The appropriate restriction will be determined via self-assessment.  For those in occupational pension schemes, where tax relief will already have been received at an individual’s marginal rate, a tax charge will be payable to claw back the excess tax relief.
What if I can’t afford to pay the tax charge?	The Government is proposing that individuals will have the option to request that tax charges are paid by the pension scheme, with benefits reduced accordingly, referred to as a “Scheme Pays” option.  However, this option is likely to be available only in certain circumstances and a lot of the detail still needs to be finalised.
Can I pay extra contributions now in advance of the changes coming into force?	There are “anti-forestalling” measures designed to stop anyone with income in excess of £130,000 benefiting from full tax relief on additional contributions paid in advance of the changes coming into force in 2011.

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