

# LGPS Briefing Note

## Restrictions on Pensions Tax

### August 2010

#### Coalition Government Consults on an Alternative Approach to Restricting Tax Relief on Pensions

Following commitments made at the June Budget, David Gauke MP, Exchequer Secretary to the Treasury published nine documents on 27 July relating to tax for consultation and discussion.

Among them was the keenly awaited alternative proposals to the previous Government's complex arrangements to restrict tax relief for high earners, due to commence 6 April 2011.

The paper sets out the detail of the policy and range of policy and design issues that need to be decided in "any" new regime and readers are reminded that unless alternative arrangements are agreed, the current complex high earners legislation remains law and comes into effect on 6 April 2011, the Government having undertaken to repeal current legislation only when it has decided on the detail of the new approach.

#### Background

It had been calculated that in 2008/2009 a quarter of all pension tax relief went to the 1.5% of members in pension schemes earning over £150,000. With the introduction of a 50% tax rate this was set to increase still further and plans were made to no longer allow tax relief on contributions at the rate of tax paid by high earning individuals.

As set out in the Finance Act 2010, tax-relief on "high earners" pension contributions is to be restricted from 6 April 2011 so that it tapers away for those earning over £150,000 from 50% to 20% for those earning £180,000+.

Those earning over £130,000 will also have the value of their employer's contributions added to their earnings and where this takes them over the £150,000 threshold, tax will also become payable on the value of the employer contributions (which is not the amount of the contributions in a defined benefit scheme) at 30%. Cliff edges exist and large tax payments can become payable although the actual income may not be received for many years.

To prevent people making substantial additional pension contributions, taking full tax relief before the changes in 2011, new rules known as anti-forestalling were applied from 22 April 2009. They affect those who earn over £130,000 per year and who change their normal ongoing regular pension savings or those whose pension savings in a tax year exceed a threshold of £20,000 or the lower of £30,000 and average contributions over the past three years, if contributions are less regular than quarterly. Transgressors suffer a recovery charge, currently 20%, which is generally processed via their Self-Assessment tax return. The anti-forestalling measures continue in place.

#### The Government listens!

While the Government has confirmed that it will continue with plans to raise at least the same level of revenue by the restriction of tax relief, it has listened to concerns raised by the pensions industry and employers about the complexity of the new arrangements and the unintended consequences for pensions savings. The consultation now issued considers an alternative simplified approach involving the reform of exiting allowances, including significantly reducing the current annual allowance by which a pension pot may grow from £225,000 to between £30,000 and £45,000.

An annual allowance somewhere between £30,000 and £45,000 with an increase in the factor used to calculate the value of the pension from 10 to between 15 and 20 could maintain the levels of tax income to the Treasury anticipated from the current arrangements to restrict tax relief for high earners from 6 April 2011.

In order to ensure that a much lower annual allowance operates fairly and effectively, various features will need to be revised and interested parties are requested to engage with the process to determine the best design for the new system.

## The Proposals

### Annual Allowance

Currently the start and end of year pension values are each multiplied by 10 and added to the lump sum value with one then subtracted from the other to arrive at the growth figure to be compared to the annual allowance of £225,000 as follows:

$$[(10 \times \text{Pension End}) + \text{Lump Sum End}] - [(10 \times \text{Pension Start}) + \text{Lump Sum Start}]$$

**Plus any AVC contributions that are made over the year**

Where the resulting figure is less than the annual allowance, no additional tax charge arises; where it does, a charge of 40% on the excess figure applies, to be declared and paid through the annual Self-Assessment tax return by the member.

Restricting the annual allowance to between £30,000 and £45,000 and increasing the multiplication factor from 10 to 15 to 20, will clearly catch many more people, including those who are considerably lower paid than those under the current legislation and could catch those whose pension entitlement increases by just £2,000 in a year.

The tax charge would apply at a tailored rate to the contributions above the annual allowance so that effectively no tax relief would be received. Consideration is to be given as to how the increase in value of the pension would be calculated.

The annual allowance may, however, be index linked and one off spikes in contributions may be allowed. Exemptions may be put in place for those who die or are diagnosed with a terminal illness.

Payment of the actual charge would be likely to continue to be paid from current income though the Self-Assessment tax return, but consideration will be given as to how this should be handled when large payments are due.

### Lifetime Allowance

Currently set at £1.8M, it is proposed that this could reduce to £1.5M and that the value of rights covered by primary and enhanced protection could be frozen, thereby simplifying the operation of the protection rules.

### Capping Tax Relief

It is proposed that tax relief is capped at 40% below the annual allowance, including for 50% tax payers. This is estimated to yield additional tax revenue of around £500M a year which could be used to enhance the level of the annual allowance.

#### *Example of current Annual Allowance check:*

*LGPS member who's pay has increased in the year from £50,000 to £60,000 with 20 years membership*

#### *Benefits at End: 20 years membership*

*Pension = (17/80 x £60,000) + (3/60 x £60,000) = £15,750*

*Lump Sum = 3 x 17/80 x £60,000 = £38,250*

#### *Benefits at Start: 19 years membership*

*Pension = (17/80 x £50,000) + (2/60 x £50,000) = £12,290*

*Lump Sum = 3 x 17/80 x £50,000 = £31,875*

#### *Annual Allowance (AA) check*

*[(10 x £15,750) + £38,250] – [(10 x £12,290) + £31,875]  
= £40,975*

*Less than AA (£225,000) therefore no tax charge.*

## The Key Policy Design Issues to Resolve

The consultation details and seeks views and information on key policy design issues to resolve. These fall into the three categories below, with an overriding aim that the risk of enabling avoidance should be minimised:

**Policy Design** - including the level of the annual allowance and how the pension accrual in defined benefit schemes would be valued.

**Managing Impacts** - including options to protect basic rate taxpayers and to support hard cases caused by one-off spikes in pension accrual.

**Design and Delivery** - including how compliance and delivery will operate, which could include a requirement for schemes to report to HM Revenue and Customs when individuals exceed a set limit.

## Summary

In a welcome move, the proposed alternative approach to restricting tax relief for high earners will remove much of the complexity of the current legislation and negate the fear that by the law of unintended consequences those high earners hit by punitive tax demands making them less likely to stay in their workplace pension schemes, will in turn display less desire to maintain a good pension scheme for their wider workforce.

With the proposals designed to bring in as least as much tax revenue as the legislation it is to replace, and possibly more, the alternative approach will, however, affect a significantly larger group of tax payers and encompass those earning significantly less than £130,000 per year. It may encompass those whose pension pot grows by as little as £2,000 in a year.

The consultation closes on 27 August 2010 and the Government will look to confirm its approach by the end of September 2010. Repeal of the existing legislation will take place if it is decided that the alternative approach will meet the Government's objectives. New draft legislation will then be published in the autumn for consultation and legislation will then be included in the Finance Act 2011 and effective from 6 April 2011.

With the Government committing to a more considered and open approach to tax policy making, with consultation and scrutiny of their tax policies being the cornerstone of their policy making, relevant parties are encouraged to provide their feedback on the consultation together with evidence in support of suggestions.

Responses should be sent to [pensionsax@hmtreasury.gsi.gov.uk](mailto:pensionsax@hmtreasury.gsi.gov.uk)



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