

Public Sector Pensions Briefing Note – December 2010

Restricting Pensions Tax Relief – The Story Continues

Introduction

In October 2010, HM Treasury released its proposals for an alternative approach to restricting tax relief on pensions. Our Briefing Note Restricting Pensions Tax Relief - Revised Proposal Announced provides a summary of the proposals which were based around reductions in the annual and lifetime allowances.

At the time of the release, a number of issues remained to be resolved and the consultation and development process was set to continue so that the Government could establish a new system and repeal the legislation that would otherwise introduce the more complex restrictions on tax relief on pension contributions for high earners with effect from April 2011.

Two further consultations have now been released. The first addresses the issue of meeting high annual allowance (AA) charges where the carry forward of any unused allowances is insufficient, and the second concerns the Finance Bill 2011 and includes details of the lifetime allowance (LTA) protections and AA serious ill health exemptions.

Meeting high annual allowance charges from pension benefits

Background

With effect from April 2011, the Government proposes that the AA, the amount by which a pension pot may grow in a year before additional tax becomes payable, will reduce from £255,000 to £50,000. The proposed method of calculating pension growth in a defined benefit scheme is detailed in our earlier Briefing Note.

Although the Government anticipates that the circa 100,000 people, who currently exceed the £50,000 threshold and



their employers will adapt their approach to pensions and remuneration so that pension growth falls below the limit, they recognise that this is more complex for members of defined benefit schemes who may inadvertently fall above the level from time to time. The carry forward of up to three years unused allowance is designed to assist members who normally have pension savings below the limit, but who exceed the limit from time to time, to avoid an additional tax charge.

The proposals now released are targeted at helping the anticipated few members who incur a substantial charge to meet it, if it is not manageable from income, by reduction to their pension benefits. These are likely to be those members who are highly paid with lengthy service in a final salary scheme, who regularly come close to or exceed the threshold.

The Options

It is proposed that, in any event, the first £2,000 to £6,000 of a tax charge be paid from current income with two options presented for consideration to meet the balance where an individual does not wish to also meet it from current income.

1. Reducing pension benefits in real time while benefits are accruing, with the scheme paying the tax charge at that time
2. Rolling up the tax charge liability and deferring its payment to the point when benefits crystallise, with reduction to pension benefits at that time. This would involve the annual application of the normal late payment of tax interest rate to ensure that the full value of the tax is maintained over the time lapse to payment. Member records will require an annual update.

The member's marginal rate of tax will be required in order to work out the tax charge to be met and to calculate the consequent reduction to benefits or the amount to be up rated by interest each year under options 1 and 2 respectively. Upon crystallisation, LTA calculations will take place using the reduced pension values.

The Government has indicated that it will take forward the option that the consultation establishes best meets its objectives to:

- ensure that tax is manageable, but not reduced
- guard against tax avoidance, fraud and error and ensure that all tax due is collected
- minimise delay in payment of tax
- minimise the administrative impact on all stakeholders.

Increased administration will arise however. For example: members will record details on their Self Assessment tax return and HMRC will carry out cross checks with the scheme; rather than prescription it is proposed that each scheme agrees how the pension reduction is calculated; members may need to be kept informed of how their future benefits have been affected and, given the potentially long term nature of the second option, records may need to be kept for many many years.

Further information and next steps

The full discussion document 'Options to meet high annual allowance charges from pension benefits' containing further detail and 13 specific consultation questions can be found at: http://www.hm-treasury.gov.uk/consult_pensionsrelief.htm. Responses should be submitted by 7 January 2011.

Legislation to enable individuals to meet AA tax charges from their pension will be included in the Finance Bill 2011 and the draft clauses will be issued in February 2011.

Finance Bill 2011

Background

As well as the reduction to the AA in April 2011 detailed above, with effect from April 2012, the Government proposes that the LTA, the maximum capitalised amount of pension that may be accrued over a lifetime before additional tax becomes payable, will reduce from £1.8M to £1.5M.

Draft regulations concerning the reduction in the AA were released in October, with more regulations to follow as various aspects of the AA and LTA reductions were developed. These will form part of the vast clauses of the Finance Bill 2011, the draft of which has recently been released for consultation along with explanatory notes.

Included in the release are the details of how the reduction in the LTA and transitional protections will work, and revised and new clauses relating to the AA, including details of the proposed exemption for severe ill health retirement cases.

Further draft clauses remain outstanding and will be released in 2011 as mentioned elsewhere in this Note.



Lifetime Allowance

A regime is proposed to protect members who may already have built up pension savings in the expectation that the LTA would remain at £1.8M. It will enable those members to apply for protection of £1.8M if greater than the actual LTA at the time of their first benefit crystallisation event, but only so long as they no longer contribute to a defined contribution scheme, or actively accrue pension benefits in a defined benefit scheme such that they increase above the rate of their scheme's normal annual inflationary uprating as specified in their scheme rules on 9 December 2010, or where this was not specified, by CPI. Applications for the protection must be made before 6 April 2012. Applications cannot be made if a member already has primary or enhanced protections as these protections will continue to be valid.

Members with protection will need to take care regarding auto enrollment into schemes as, unless this is under the new auto enrollment arrangements arising from the Pensions Act 2008 with subsequent opting out within a month, this could cause the protection to be lost. Members may need to opt out prior to commencement of further employment and will need to fully understand the protection and its rules.

A further protection is included in respect of members who die prior to April 2012, where payments are made after that date. In this event the LTA will remain as £1.8M.

Finally, it is confirmed that the trivial commutation link to the LTA, currently 1%, is broken, and the sum is set at £18,000 with provision made for any future increases to be made by way of Treasury Order.

Annual Allowance

The revised draft AA clauses tidy up a few drafting issues and make provision for dealing with post retirement pension enhancements where the main purpose of these were to avoid or reduce an AA charge and for the carry forward of unused allowances arising from membership of currently relieved non-UK pension schemes.

They also provide the detail for the exemption from the AA charge for severe ill health retirement cases. In summary, it is proposed that this apply where the member becomes entitled to all the benefits under their pension arrangement where the scheme administrator receives evidence from a registered medical practitioner that due to ill health the member is unlikely to be able to undertake gainful work in any capacity at any time in the future other than to an insignificant extent, or becomes entitled to a serious ill health lump sum under their pension arrangement.

The exemption from the AA charge for all ill health retirements previously under consideration has not currently materialised.

Further information and next steps

The full documentation including the draft HMRC guidance on how the LTA and protection regime will work can be found at: http://www.hm-treasury.gov.uk/finance_bill_2011.htm
Responses should be submitted by 9 February 2011.

Conclusion

Further consultations on aspects of the new regime remain to be issued in early 2011, notably the draft regulations to cover the provision of information to members, but as the finer detail of the proposed replacement regime for restricting pension tax relief emerges, it is clear that the system will retain a significant degree of complexity and will continue to keep pension practitioners occupied for some time to come.

For further information

If you would like to discuss these issues further please contact your usual Barnett Waddingham consultant.

Alternatively, email: publicsector@barnett-waddingham.co.uk

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