

Pensions Tax Relief

Briefing Note

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Informed Choice
Independent Financial Advice

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Introduction

Mark Hoban MP, Financial Secretary to the Treasury, has announced some significant changes to pension tax relief.



The headline announcements included a reduction in the Annual Allowance for tax-privileged pension saving from £255,000 to £50,000. The Lifetime Allowance is also being reduced from £1.8m to £1.5m.

The Annual Allowance change will come into force on 6th April 2011 and both changes are expected to raise around £4bn of annual revenue.

Pensions remain an important part of retirement planning for many people. The tax relief available on contributions and the tax efficient investment environment for pension funds make them very attractive as a retirement planning vehicle.

These announced changes to the Annual Allowance and Lifetime Allowance came about as a result of unnecessarily complex proposed changes made by the previous government. These resulted in two years of 'anti-forestalling' measures to prevent higher earners from making large pension contributions ahead of the changes.

Had the original changes been introduced, we would have seen pension tax relief limited for those with earnings over £150,000 per annum, with the available higher rate income tax relief 'tapered' down depending on the level of earnings.

Within this briefing note we look at the new rules in greater detail and consider some of the implications, particularly for those with higher value pension funds and those in defined benefit (final salary) pension schemes.

Please do let me know if you have any questions. You can call me on 01483 274566, email martin@icl-ifa.co.uk or talk to me on Twitter @martinbamford.

Annual Allowance

The Annual Allowance sets the maximum pension contribution that can be made each tax year.

For defined contribution pension schemes, such as personal pensions, contributions each year are limited to the Annual Allowance. For defined benefit schemes, it is the total amount of pension benefit accrued each year.

For the 2010/11 tax year, the Annual Allowance is £255,000. The Treasury announcement means that, for the 2011/12 tax year, the Annual Allowance will be reduced to £50,000.

The Treasury believes that this reduced Annual Allowance will affect approximately 100,000 pension savers each year. 80% of these pension savers will have income exceeding £100,000 per annum.

For people in defined contribution schemes, this change to the Annual Allowance will be fairly easy to interpret and understand. They will be able to receive income tax relief at their highest marginal rate on contributions up to 100% of their earnings, subject to the Annual Allowance of £50,000.

People in defined benefit schemes are likely to have a tougher time understanding the new rules.

As well as seeing the Annual Allowance reduced from £255,000 to £50,000, the factor used to convert defined benefit pension scheme accruals to translate this into the Annual Allowance is being increased from 10 to 16.

This means that, for example, someone in a defined benefit scheme who accrues a benefit of £5,000 in a single year will breach the new Annual Allowance by £30,000. This could be prompted by an event such as a pay rise, particularly for those with longer periods of service.

Because of this, the Treasury is planning to allow unused allowance from the previous three years to be carried forward and applied against an excess contributions or accruals. This will apply to both defined contribution and defined benefit schemes.

We understand that it will still be the case that no Annual Allowance will apply in the year that people take retirement benefits. This means that, theoretically, it will be possible to contribute up to 100% of earnings in the year of retirement (or accrue substantial defined benefits) with no penalty.

Under current rules, contributions or accruals in excess of the Annual Allowance are subject to a tax charge of 40%. This applies when contributions are made by the employee or employer. Exceeding the Annual Allowance is something you must declare through Self Assessment.

Lifetime Allowance

The Lifetime Allowance is the limit on the total amount of pension benefits you can draw from before tax penalties are applied.

In the 2010/11 and 2011/12 tax years, the Lifetime Allowance is £1.8m. As a result of this announcement from the Treasury, it will be reduced to £1.5m for the 2012/13 tax year.

This takes the level of the Lifetime Allowance back down to the level at which it was originally introduced for the 2006/07 tax year.

Pension benefits taken in excess of the Lifetime Allowance are subject to a recovery (tax) charge. The level of this recovery charge will depend on how benefits are taken.

For retirement benefits taken as an income, the recovery charge is 25% on the balance over the Lifetime Allowance. The pension income is also subject to income tax as usual. Where excess pension benefits are taken as a lump sum, they will be subject to a 55% recovery charge.

When the Lifetime Allowance was introduced in April 2006, pension scheme members with larger pension funds had a couple of choices to protect themselves from recovery charges in the future. They could select Primary Protection or Enhanced Protection.

Primary Protection was available where pension savers already had benefits in excess of £1.5m on 6th April 2010. It converted the value of their total pension savings on that date to a percentage of the Lifetime Allowance, giving them a personal Lifetime Allowance.

Enhanced Protection required that pension savers stop actively contributing or accruing benefits in registered pension schemes from 6th April 2006 onwards. It allowed all pension benefits built up to that date, plus any investment growth or time-based accruals, to be exempt from the recovery charge.

We understand that both Primary Protection and Enhanced Protection will continue to be valid methods of protecting larger pension funds from recovery charges.

Once again, the situation for those with defined benefits is more complex than for those with defined contribution pension benefits. Assessing a defined contribution pension scheme against the Lifetime Allowance is a simple case of comparing the total fund value to the Lifetime Allowance figure.

For those with defined benefits, we understand that the current conversion factor of 20:1 at retirement will continue to be applied.

It is interesting to note in the report from the Government Actuary's Department on reducing the Annual Allowance and setting the valuation factor for this, they comment that the 20:1 conversion factor would have been higher if set today, due to higher life expectancy and lower discount rates.

Assuming the 20:1 factor remains in place, this means that those with defined benefits higher than £75,000 per annum would breach the new Lifetime Allowance, assuming they had no Primary or Enhanced Protection in place.

Conclusions

As with all announcements relating to pensions, the devil is often in the detail. We suspect that there will be more to come once the dust has settled and various pension commentators have had the opportunity to consider all of the implications.

We urge pension savers to consider these changes now and start planning for them ahead of the 2011/12 tax year.

The anti-forestalling measures introduced, and then updated, by the last government remain in force for the 2010/11 tax year, restricting to some extent the planning opportunities for higher earners.

Those who have registered for Primary Protection should seek professional advice to understand the impact of a lower Lifetime Allowance on their own retirement planning. It is important to update any assumptions and projections originally used when advice to adopt Primary Protection was received.

Active or deferred members of defined benefit pension schemes should pay particular attention to these changes as these individuals could find it the most difficult to understand the implications. Those with lengthy periods of service in defined benefit schemes, higher earners and those who have accrued benefits approaching the £75,000 per annum level are in particular need of professional advice.

We need to wait until November to see details of how pension tax charges, triggered by events such as paying greater contributions than the Annual Allowance, might be paid out of pension funds rather than out of income through the Self Assessment system.

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