Pensions Talk, July 2015

Budget Special

Pensions Tax Relief to be cut for high earners

The government have announced that with effect from April 2016, tax relief will be restricted for anyone earning over £150,000 a year, by way of reducing the Annual Allowance for high earners.

The present pension tax relief system allows employees to receive tax relief on the contributions they pay at their highest marginal rate. For anyone with earnings over £150,000 a year this means they could potentially receive tax relief at 45% on the contributions they pay. However the government have become concerned that the tax relief system is disproportionate, meaning that a minority of high earners receive the majority of tax relief granted.

At present, it is possible to pay up to 100% of salary, subject to a limit known as the Annual Allowance, into a pension arrangement with tax relief. The 100% of salary must include all contributions an employee pays into any pension arrangement. The Annual Allowance must also include any amounts paid in by an employer on the employee's behalf. The standard Annual Allowance is currently £40,000. In some cases it is possible for an individual to pay in over the Annual Allowance by using unused relief from the previous three tax years. For those who have accessed their pension under the new pension flexibility that came in from April, the Annual Allowance may be reduced to £10,000.

George Osbourne has now announced that with effect from next April, as a way to cut the tax relief for high earning individuals, the Annual Allowance will decrease for anyone earning between £150,000 and £210,000 a year by £1 for every £2 of income in this bracket. For anyone earning over £210,000 the Annual Allowance will be restricted to £10,000.

It is important to note that "earnings" in this respect must also include pension contributions so it will not be possible for someone to use salary exchange in order to reduce their earnings below this threshold. However, in order to ensure that these measures are focused on those who currently benefit most from the tax relief, anyone with an income, excluding pension contributions, of below £110,000 per annum will not be affected.

The new proposals build another layer of complexity into an already complex system and to some extent prevents pension planning for high earners. For some it may be difficult to calculate if they will exceed this limit, particularly where bonuses are perhaps payable at the end of the year.

The current Annual Allowance system revolves around what is known as a Pension Input Period (PIP). For trust based pension arrangements these will usually be in line with the scheme year. For members of contract based arrangements such as a Group Personal Pension, the PIP will depend upon when the members joined the pension and the date the first contribution to the plan was made. A PIP may, or may not, be in line with the tax year. The Annual Allowance applicable is that in force in the tax year in which the PIP ends. This would mean that ordinarily anyone with a PIP which ends after 5th April 2016 would effectively already be impacted by these new rules. However, the government has announced that they plan to align all PIP's to the tax year with effect from April 2016. This means that all current PIPs will end on 8th July 2015. A new PIP will then be created running from 9th July 2015 to 5th April 2016. There are also transitional measures being introduced which mean that effectively individuals will be able to contribute up to £80,000 for all PIPs ending in the 2015/16 tax year of which a maximum of £40,000 can be paid between now and the end of the tax year.

These changes are likely to have significant impact on any employees earning over £110,000 a year. We will be producing a communication for high earners to help them understand these changes and to see how they are likely to be impacted. We will also be working with employers to look at how this impacts on pension strategy for high earners.

Potential Overhaul of the Pensions Tax System

In the Budget, George Osbourne has stated that he plans to review the current pension tax system to consider if this should be altered to operate in a similar way to that applicable to ISAs. The government has now opened consultation to gauge opinion on what will no doubt be a hot topic.

At present, the taxation system for pensions operates as follows:

Contributions

An employee will receive tax relief on the contributions they pay at their highest marginal rate (so either at 20%, 40% or 45%). Non-taxpayers can also receive tax relief at 20%.

Employer contributions are not taxed as a benefit in kind on the employee and are generally allowable as a business expense.

Investment

Any investment growth within a pension scheme is generally tax free. There is a small element of tax which arises from a pension scheme no longer being able to reclaim the corporation tax credits associated with dividend payments.

Benefits

When an individual draws benefits from their pension arrangement, the first 25% of the fund is generally tax free. The remaining 75% is subject to Income Tax.

Anyone with total pension benefits in excess of the Lifetime Allowance (currently £1.25 million for 2015/16 tax year but due to decrease to £1 million from next April), will face a tax charge on the excess above this limit (usually 55%).

The Chancellor is now proposing that the tax relief system be altered so that pensions operate in a similar way to an ISA. This would mean that no tax relief would be received on pension contributions but any benefits payable from a pension would be tax free.

Whilst this sounds simple in theory it does bring up a number of complications in practice. For example, the pension tax relief system has been in place now for many years meaning that many people will already have received a substantial amount of tax relief on the contributions already paid into pensions. Will they then be able to take this all tax free? This is unlikely to be the case so how will this be managed within the system?

Will employer pension contributions be a taxable benefit in kind on the employee? Presumably yes otherwise there would be a significant increase in the use of salary exchange (which the government have already said they want to keep an eye on). If they are a taxable benefit in kind this would of course result in a Class 1A employer National Insurance liability.

Will the minimum age at which you take your benefits be reconsidered or will employees be able to access some or all of their pension fund before the minimum age in certain circumstances? If not, what incentives will there be to tie up your income for potentially a significant amount of time?

If introduced, these changes would represent a significant overhaul to the current tax system that has been in place for many years. The consultation period for this is due to finish on 30th September 2015. We will of course keep you updated on any developments.

Other Budget Pension News . . .

Salary Exchange

In the build up to the budget it was rumoured that the Chancellor may look at restricting or removing the benefits associated with salary exchange (also known as salary sacrifice).

Salary exchange is whereby an employee agrees to give up part of their salary in exchange for another benefit (for example, an additional employer pension contribution). In doing so there is usually a National Insurance saving for both the employee and the employer.

Fortunately, there have been no changes made to the current system in this budget. However, the Chancellor has announced that the government will “actively monitor the growth of these schemes and their effect on tax receipts”. This may mean that these will potentially be withdrawn in the future.

Lifetime Allowance

As per the March budget, it has been confirmed that the Lifetime Allowance will reduce to £1 million from April 2016. We looked at the implications of this in our newsletter earlier this year.

Transitional protection for those with benefits already in excess of £1 million will also be introduced.

Pensions Flexibility

Pensions Flexibility was introduced from April this year and increased the options for taking benefits from Defined Contribution pension pots. This includes the ability to take the whole pot as a cash lump sum, if desired. Whilst individuals do now have this flexibility it is up to pension providers to decide what options they will and won't offer to their customers.

The government wants to ensure that people can access their benefits under the new flexibilities easily and at a reasonable cost. Consultation will now begin aimed at making the process for transferring pensions from one scheme to another quicker and smoother and avoiding any excessive early exit penalties.

Pension Wise

Alongside the Pensions Flexibility introduced from April, a new, free guidance service was introduced which allowed anyone aged 55 or over with a Defined Contribution pension pot access to a free 45 minute guidance session. These are aimed at helping individuals understand the options available to them. Following the success of the new flexibilities (over 85,000 are thought to have taken advantage of these), the aim is to now extend this service to those aged 50 and over.

Secondary Annuity Market

In March's Budget it was also announced that the government plans to consult on introducing a secondary annuity market. This would allow those who have already purchased an annuity to sell this to a third party. It was expected that individuals would be able to exchange their annuity in this way from April 2016. However, following consultation, they have now decided that implementation should be delayed until 2017.

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