

Pensions Relief and Income Tax Changes

Your higher earning employees may be in for an unexpected tax bill!!

The last few years of Pensions “Simplification” have been anything but ‘simple’, but just as we had become, perhaps, comfortable with the new post A Day rules dearest Darling Alastair has popped another couple of pebbles in the tax rule pool and rippled the waters yet again.

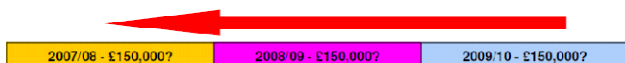
The intricacies of the combined effects of restrictions in personal allowances and now the reductions in pension’s tax relief for higher earners are enough to make a rocket scientist reach for a damp towel and a Nurofen. Coupled with the rules on anti-forestalling you could be forgiven for thinking someone at the revenue has had something of a change of heart over the simplification on pensions! What is clear is that employers, and their highest paid staff, are going to need help.

Employers in particular need to be aware of how these changes may effect some of their most senior employees as if they don’t take action to brief them then there are going to be some very disgruntled senior employees out there who suffer very substantive increases in their tax bills.

The details

Relevant Income

- Income in excess of £150,000
- Relevant income is:
 - Identify total income (from all sources)
 - Add pension contributions from net pay arrangements
 - Deduct any income tax deductions and reliefs other than pensions
 - Deduct pension contributions in tax year up to max of £20,000
 - Add income given up post 22/04/09 salary sacrifice
 - Deduct grossed up gift aid
- The £150,000 limit is not just for this year, BUT either of the last two years



In essence anyone earning in excess of £150,000 of “relevant” income (see left) from 2011 onwards will progressively lose the benefit of additional higher rate relief on pension contributions that exceed £20k per annum. Those with relevant income exceeding £180,000 per annum see tax relief restricted to 20%. There is no intention to increase the £180,000 limit so it will capture ever increasing numbers of employees over time.

The definition of ‘relevant’ earnings, and the fact that the revenue will apply this definition to income earned in the last two years, is designed to prevent measures to circumvent the new rules in the run up to 2011. It is important to note that Decembers Pre-Budget report announced measures that now mean employer contributions to the employees pension need to be added to the definition of earnings shown above for all employees earning more than £130,000 PA.

Some Examples

The implication of this then is if you have an employee earning £129,999 PA then they will be able to gain individual tax relief on personal contributions they make to a pension up to the equivalent of 100% of their salary, even if you make a substantial contribution for them as an employer (the total combined amount that could be paid and qualify for relief is limited to £245,000 for 09/10).

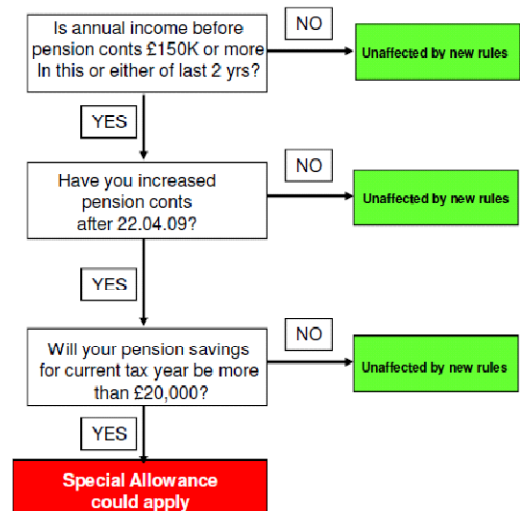
If your employee is, or has in the last 2 tax years, earned ‘relevant’ income (defined above) of between £130,001 to £149,999 then they will not face restrictions to the relief on their personal

contributions if when you add in the value of your employer contributions the total is less than £150,000 per annum.

All other employees earning in excess of these amounts, and having total aggregated pension contributions exceeding £20,00 per annum, progressively lose the benefit of additional higher rate tax relief on their personal contributions. Significantly though they also face an additional income tax charge on the employer contributions to their pension arrangements. This presents some very real issues for the employer. If your contract with the employee says they are due a pension contribution of a certain % of their pay then you are obliged to honour this. In order to change it, potentially for the members benefit, then you must novate that element of the contract. This may require you to undertake a consultation period with the employee(s) concerned of 2 to 3 months as a minimum.

Are there any concessions?

In order to avoid criticism of the rules being applied retrospectively there are some concessions. In particular these apply to members who have consistently been making contributions in excess of £20k per annum prior to the 22nd of April 2009. It should be noted that in order to qualify as being a 'regular' contribution the amount must have been paid at least quarterly. Payments made less frequently will be averaged over a 3 year period and then added to any regular amounts to establish an average. If, by this definition, the average exceeds £20,000 then they will be able to continue to benefit from tax relief on up to a maximum of £30,000 (or their actual average if lower).

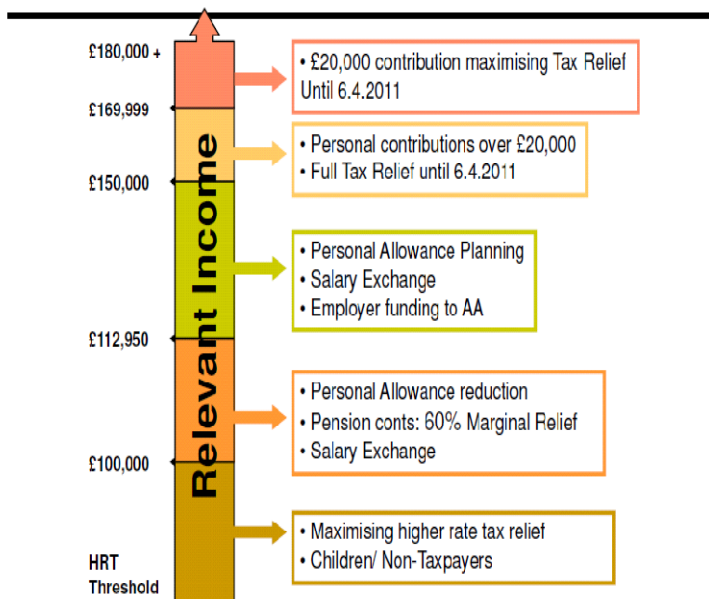


It appears that to continue to use this 'Protected Input Allowance' the member must continue to use the same pension scheme, i.e. this status is lost if they discontinue the scheme into which they have been making contributions and start up a new one after April '09. This will reduce choice and flexibility for the future unless they take advantage of schemes which offer the possibility of members moving accumulated funds over to an internal SIPP option – thus giving them a much wider range of possible investment choices. There is a concession offering the opportunity for schemes with at least 20 or more members making contributions on the same basis to move as a block to an entirely new scheme while still retaining the Protected Input Status of individuals within the scheme. However, the rules concerning how the "same basis" of contributions are to be assessed are far from clear at this stage.

Planning opportunities

As with all change, particularly complex change, there remain numerous opportunities for employers and employees to plan to minimise the impact of these changes. As with all planning the sooner you look at it the more certain you can be of achieving a desirable outcome.

Budget 2009 – Summary of Pension Planning to 6th April 2011



Clearly all those earning over £150k should regard the £20k pension contribution allowance in much the same way as the ISA allowance has always been perceived, i.e. "USE IT OR LOSE IT"! It also is important that they take full advantage of the phasing in of the tax relief restrictions for the next two tax years. As these individuals will be getting taxed at 50% on income in excess of £150k then it makes even more sense for them to consider making pension contributions of up to £20k (£30k if they benefit from a Protected Input Allowance rules) to absorb this additional tax.

As we stand, anyone taking advantage of the rules allowing them to make contributions greater than £20k PA will be restricted to doing so into the pension product they have been using. A transfer elsewhere could immediately mean the loss of the exemption – although a group transfer (involving 20 or more members) may offer a possible exit.

It also makes good sense for employees earning more than £100k to make sufficient contributions to recover the restrictions that would otherwise apply to their personal allowances. You can see from the chart above that the progressive reduction in the Personal Allowance that applies to anyone earning more than £100,000 per annum means it is possible to achieve a marginal tax relief rate here, if they use salary exchange as a payment method for any personal contributions, of up to 60%.

It is also worth noting that the increases to National Insurance which are due to take effect from the beginning of the 2011 tax year will further increase the attraction of the Salary Exchange method of making personal pension contributions, not just for higher earners but for all employees.

While there is likely to be no tax gain in making employer contributions for those earning more than £180,000 per annum it may well still make sense for such employees to make personal contributions exceeding £20,000 per annum if they are likely to be paying tax at no more than basic rate when in receipt of their pension. This is because their fund still grows tax free and a quarter of it will be available as tax free cash in any event so there is still potentially a tax relief gain for them. However, for those close to retirement, who anticipate paying either 40 or even 50% on their post retirement income then it simply makes no sense for them to consider further personal contributions to a pension when compared to making a contribution to an ISA instead, to illustrate this;

For every £100 contributed for an earner on more than £150,000 PA the net cost after tax relief is £80.

If they immediately retired and withdrew their £100 fund they would be able to take £25 as tax free cash. The remaining £75 will produce a taxed income which, when all withdrawn, will result in tax (at 50%) of £37.5.

This individual will then have paid an additional £17.5 (this £37.5 in tax less £20 in tax relief) due the making the £100 pension contribution than they would have paid if they had made the contribution to an ISA where the income could be drawn out tax free.

Summary

Clearly the issues now surrounding employer and employee pension contributions for anyone earning more than £100,000 per annum have now become extremely complicated. It is difficult for an employer to be certain of the best strategy to follow as the personal circumstances of two employees earning exactly the same amount might dictate an entirely different approach.

What is clearly is that action is needed to avoid potentially significant numbers of your higher earning staff suffering undue tax consequences which they may then feel inclined to feel you should have warned them about.

How can Lighthouse Group Employee Benefits help?

We can consult with you on changes you may need to make to your remuneration strategies for your senior executives and high earners. We can assist you by identifying effected employees and mapping out the employer/member options. We can also deliver the advice needed at a 1:1 with effected employees to help them decide on the actions they may need to take in order to minimise the impact of these changes. We can also help with the advice and administration of group transfers and the deployment of group schemes which offer Bed and Sipping options.

If you would like further details then please do contact Steve Howard at Lighthouse Group Employee Benefits on 0161 819 4940, email him on steve.howard@lighthousegroup.plc.uk, or visit us on the web at www.lighthouseGEB.co.uk.

Thanks to Winterthur and Scottish Widows for the graphics used in this article.