In Depth

More changes for pensions tax

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Contents

The Summer Budget included an outline of further complex changes to the annual allowance for high earners, from the 2016/17 tax year. As part of these changes, the 'pension input periods' over which pensions savings are measured for annual allowance purposes are being aligned for all pension savers. This alignment starts to take effect from 8 July 2015 – the date of the Summer Budget.

A Finance Bill was published just before the summer recess, setting out further details of these measures. Changes could be made as the Bill passes through Parliment.

This In Depth explains these proposals and puts them in context of the wider changes to pensions tax legislation currently in the pipeline.

Background

Pensions savings in excess of an 'annual allowance' are subject to a tax charge. The allowance is currently £40,000, although individuals can carry forward unused allowance from the previous three tax years (and a higher allowance of £50,000 applied from 2011/12 to 2013/14).

For testing against the annual allowance, benefits are valued over the '**pension input period**' (which can vary from scheme to scheme) ending in the relevant tax year. This value is referred to as the '**pension input amount**' and is, broadly:

- The amount of contributions paid to each money purchase arrangement, PLUS
- The value of additional benefits accrued in each defined benefit arrangement.

Defined benefits are calculated in a prescribed way for annual allowance purposes and the resulting pension is valued using a factor of 16. When assessing the additional benefits earned over the year, the pension at the start of the pension input period is uplifted by CPI inflation. For deferred members, where the increase in defined benefits falls below a threshold based on typical increases in deferment, such benefits can be ignored (the 'deferred member carve out').

The individual is generally subject to tax at their marginal rate on any pension input amount in excess of their annual allowance (taking account of any unused allowance carried forward from previous tax years).

Individuals can either pay the charge directly, through the self-assessment process, or ask the scheme to pay the charge in return for a reduction in benefits. This alternative approach is known as 'scheme pays' and schemes are only obliged to offer this option where the input in that scheme exceeds the annual allowance and the charge exceeds £2,000.

A higher charge may apply to any individuals who have accessed flexible benefits, such as by taking income from funds designated for drawdown or taking an 'uncrystallised funds pension lump sum', and subsequently save more than £10,000 in money purchase benefits in a tax year.

This is only a brief overview of the annual allowance provisions, to put the changes below in context.

Tapering the annual allowance for high earners

A tapered annual allowance will apply from 6 April 2016 to 'high-income individuals', defined as individuals with:

- '**adjusted income**' in excess of £150,000, and
- '**threshold income**' in excess of £110,000 (this threshold is defined as £150,000 less the annual allowance)

Adjusted income

An individual's adjusted income for the tax year is broadly taxable income (not limited to income from employment) net of certain reliefs allowable under tax legislation, plus the total value of pensions savings for the tax year. Lump sum death benefits paid to the individual and taxable as income would also be deducted.

In detail, adjusted income is:

- the individual's taxable income for the year, not limited to employment income, net of any reliefs allowable (more specifically, the income set out at the end of step 2 of section 23 of the Income Taxes Act 2007, net of the reliefs specifically allowable under section 24[1], and before adjustments are made for personal and other allowances).
- PLUS deductions made from employment income for employee pension contributions paid under 'net pay' arrangements (so these employee contribution arrangements, as used by most occupational pension schemes, are treated consistently with 'relief at source' contributions used by personal pensions, which would not reduce net income at this stage) or pre-2006 corresponding relief arrangements relating to non-domiciled employees with foreign employers.
- PLUS the value of the individual's total pensions savings over the tax year (using the pension input amount valuation used for annual allowance purposes) less contributions paid by or on behalf of the individual.
- PLUS any amount deducted at step 2 in relation to two relatively uncommon reliefs for pension contributions: 'excess relief' under a net pay arrangement, where the employer has not been able to deduct the full employee contributions paid from the individual's employment income; and relief that might apply where neither net pay arrangements nor relief at source are used, but the individual is entitled to relief on the pension contribution.
- LESS lump sum death benefits that are paid to the individual and taxable as income.

For those schemes that operate pension salary sacrifice arrangements, employee contributions paid via salary sacrifice are technically treated as employer contributions. Taxable income will therefore be reduced by the amount of salary sacrificed, the second bullet point above will result in no addition (because there are no 'employee contributions') and the third bullet point above will add back the full value of the pensions savings over the year.

Threshold income

An individual's threshold income for the tax year is broadly taxable income in the tax year (not limited to income from employment) net of certain reliefs allowable under tax legislation – but, unlike adjusted income, excluding the value of pensions savings. Lump sum death benefits paid to the individual and taxable as income would also be deducted. In addition, to prevent individuals entering into salary sacrifice or flexible benefit arrangements on or after 9 July 2015 in order to reduce their threshold income, the amount of income given up under certain arrangements is added back.

In detail, threshold income is:

- the individual's taxable income for the year, not limited to employment income, net of any reliefs allowable (more specifically, the income set out at the end of step 2 of section 23 of the Income Taxes Act 2007, net of the reliefs allowable under section 24[1], and just before adjustments are made for personal and other allowances).
- PLUS any reduction in income relating to a salary sacrifice or flexible remuneration arrangement made on or after 9 July 2015 in return for making increased pension provision for the individual or any person who is dependent on or connected to the individual.
- LESS any contribution paid by the individual under 'relief at source' arrangements (for this purpose the basic rate tax relief is added back - the aim is to treat these contributions, used by most personal pensions, consistently with 'net pay' contributions used by most occupational pension schemes).
- LESS lump sum death benefits that are paid to the individual and taxable as income.

One consequence of this definition is that employee contributions made by 'new' salary sacrifice arrangements on or after 9 July 2015 would be included in threshold income but employee contributions made directly would not.

1 These reliefs include, for example, those relating to certain trade and property losses but do not necessarily include all payments which may appear under "reliefs" on a tax return, such as in relation to pension contributions under 'relief at source' arrangements or gift aid payments.

A high-income individual's annual allowance of £40,000 would then be reduced by £1 for each £2 of adjusted income in excess of £150,000, down to a minimum allowance of £10,000 for those with adjusted income of £210,000 or more.

Examples			
	Andrew	**Brenda**	**Claire**
1 - Taxable income less certain reliefs	£125,000	£180,000	£125,000
2 - Employee contributions	£5,000 (paid under net pay)	£10,000 (paid under net pay)	£20,000 (paid under relief at source, with basic rate relief added)
3 - Value of total pensions savings less Employee contributions	£30,000	£30,000	£5,000
Threshold income	£125,000	£180,000	£105,000
Adjusted income	£160,000	£220,000	not needed
Annual allowance	£35,000	£10,000	£40,000
Value of total pensions savings	£35,000	£40,000	£25,000
Impact on annual allowance	**Andrew's** threshold income exceeds £110,000 and he will therefore need to consider whether the tapered annual allowance applies. Adding in his pensions savings gives an adjusted income of £160,000. This is £10,000 above the threshold for the tapered annual allowance leading to a £5,000 reduction in his annual allowance for the tax year. Andrews' pensions savings do not exceed this reduced £35,000 threshold so there would be no annual allowance charge.	**Brenda's** income is such that she is clearly subject to the tapered annual allowance. Adding her pensions savings gives an adjusted income in excess of £210,000 so the minimum annual allowance of £10,000 will apply. Brenda's pensions savings exceed this level and so, unless she has significant carry forward from previous years, a charge is likely to apply.	**Claire's** income is £125,000 but her employer's pension arrangement uses relief at source, so her income has not been reduced for member contributions. The calculation of threshold income allows for such contributions to be deducted so Claire's threshold income is below £110,000. Therefore she does not need to consider the calculation of adjusted income and the standard annual allowance of £40,000 applies.

As a reminder, tax relief on member contributions can be either:

Net pay

Pay is reduced by the amount of member contribution so that tax relief is given via payroll at the member's marginal rate. Used by most occupational pension schemes.

Relief at source

Individual pays contribution out of post-tax income. Basic rate relief is reclaimed by the pension arrangement and added to the contribution. Higher rate tax relief is reclaimed under self-assessment. Mostly used by personal pension schemes.

Anti-avoidance

Anti-avoidance provisions apply where 'it is reasonable to assume' that the main purpose, or one of the main purposes, of an arrangement is to reduce the charge payable under the tapered annual allowance provisions, by reducing the individual's adjusted income and/or threshold income in one tax year and compensating for this reduction by increasing the adjusted income and/or threshold income in another tax year. In these circumstances the annual allowance charge is calculated assuming that the income reduction had not been made.

Alignment of pension input periods

Pension input periods (PIPs) are the periods over which pensions savings are measured for testing against the annual allowance. Until July, schemes had some flexibility over when these periods could start and end.

The Finance Bill sets out significant changes, effective from 8 July 2015 (the day of the Summer Budget) which from 6 April 2016 will align all PIPs with the tax year.

In principle, the changes are intended to move to 'tax year aligned' PIPs from 2016/17 without unfairly penalising individuals or opening up tax loopholes in 2015/16. Achieving both these objectives has required some very detailed legislation.

PIP alignment

All existing PIPs at 8 July 2015 end at that date. For such arrangements, a further PIP commences on 9 July 2015 and ends on 5 April 2016.

New arrangements with PIPs commencing between 9 July 2015 and 5 April 2016 will have a PIP end date of 5 April 2016.

From tax year 2016/17 onwards all PIPs will commence on 6 April (or the relevant commencement date for new arrangements) and end on the following 5 April.

No nominations to vary PIP dates can be made after 8 July 2015.

Annual allowance charge calculation for 2015/16

For annual allowance purposes, the tax year 2015/16 is treated as two tax years:

- '**the pre-alignment tax year**', from 6 April to 8 July 2015, and
- '**the post-alignment tax year**', from 9 July 2015 to 5 April 2016.

The annual allowance charge for 2015/16 is based on the sum of the chargeable amounts calculated for both these periods individually (using the existing approach to calculating the chargeable amount outlined above, but allowing for the amendments set out on the following page).

Annual allowance for 2015/16

For the pre-alignment tax year, the annual allowance is £80,000 (rather than £40,000).

For the post-alignment tax year, the annual allowance is nil (unless the individual was not a member of a registered pension scheme in the pre-alignment period, and would therefore not be eligible to any carry forward, in which case it is £40,000). However, unused annual allowance can be carried forward from previous tax years in the usual way including from the pre-alignment tax year, although carry-forward from this period is capped at £40,000. This means that those individuals who saved less than £40,000 in the pre-alignment tax year would have scope to save £40,000 (plus any unused annual allowance available to carry forward) in the post-alignment tax year. This could provide some individuals the opportunity to save more in the 2015/16 tax year than they would have expected at the start of the year.

Example:
Andrew's pension input amount (PIA) for 2015/16 amounts to £20,000 in the pre-alignment tax year and £30,000 in the post-alignment tax year:
Pension input for the pre-alignment tax year is less than £80,000, so no charge is payable; the maximum £40,000 can be carried forward to the post-alignment tax year.
Pension input for the post-alignment tax year is less than £40,000, so no charge is payable.

Special provisions apply to any individuals who have accessed flexible benefits, such as by taking income from funds designated for drawdown or taking an 'uncrystallised funds pension lump sum'. These are extremely complicated but unlikely to apply to many individuals. Broadly, they are based on the principles above of doubling the available allowance in the pre-alignment tax year and allowing up to half to be carried forward to the post-alignment tax year.

Calculating PIAs for 2015/16

Where an individual dies or becomes severely ill in the post-alignment tax year, there will be no PIA for either the pre- or post-alignment tax year.

For defined benefit and cash balance arrangements the following amendments are made to the usual methodology:

- The input is first calculated over the combined PIPs relevant to the pre- and post-alignment tax years, for each arrangement. The calculation uses the usual method, over the combined period, except that the uplift to the opening value is 2.5% (rather than the September 2014 CPI of 1.2% which would have applied) reflecting the fact that the combined period is likely to be longer than one year.
- The test for exempting deferred members is amended similarly, so that in the threshold calculation the increase in CPI over 12 months is replaced by 2.5%.
- The PIAs for the pre- and post-alignment tax years are then derived from this total input, apportioned as follows:
  - For a member active throughout (or any scenarios not satisfying the special circumstances below): apportioned based on the number of days from the start of the pre-alignment tax year PIP to 5 April 2016, which are in the pre- and post-alignment period respectively.
  - For a member becoming deferred between 9 July 2015 and the original PIP end date (and where that end date was before 5 April 2016 and the deferred exemption would have applied between the original PIP end date and 5 April 2016): apportioned based on the number of days from the start of the pre-alignment tax year PIP to the end of the original PIP end date, which are in the pre- and post-alignment period respectively.
  - For a member becoming deferred before 9 July 2015 the input is all apportioned to the pre-alignment tax year.
  - For new arrangements commencing after 8 July 2015 the input is all apportioned to the post-alignment tax year.
  - Where the deferred member carve out would have applied to only one part of the combined period (e.g. the post-alignment tax year) the input is all apportioned to the other part (e.g. the pre-alignment tax year).

Carry forward for 2016/17 to 2018/19

For the purposes of the carry forward of unused annual allowance, the pre- and post-alignment tax years are effectively combined. There is an exception to the usual rule that carry forward is used up from the earliest available year first. The post-alignment tax year is assumed to use any carry forward from the pre-alignment year first (after the application of the £40,000 cap). After this adjustment, only the (remaining) carry forward from the pre-alignment period (capped at £40,000) is carried forward to subsequent tax years, so that:

- for 2016/17, carry forward is based on the 2013/14, 2014/15 and pre-alignment tax years;
- for 2017/18, carry forward is based on the 2014/15, pre-alignment and 2016/17 tax years;
- for 2018/19, carry forward is based on the pre-alignment, 2016/17 and 2017/18 tax years.

Example:

Andrew (in the earlier example) had £15,000 unused annual allowance carried forward from each of 2013/14 and 2014/15. For 2015/16 his carry forward from the pre-alignment period amounts to £10,000 (£40,000 less £30,000 PIA in the post-alignment period). In 2016/17 his PIA is exactly equal to his annual allowance:

for 2016/17, carry forward is £15,000 + £15,000 + £10,000

for 2017/18, carry forward is £15,000 + £10,000 + £0

Practicalities

Changes to the periods over which pensions savings are measured were effective from 8 July 2015 and affect all individuals – not just high earners.

The calculations required to confirm whether an individual is subject to the annual allowance charge are very complicated. Those saving less than £40,000 each year in the run up to 6 April 2016 should not be subject to a charge but other individuals are likely to have to consider some complex calculations to assess what charge, if any, is payable.

The charge is to be assessed and collected through self-assessment. Documents published at the time of the Budget suggested that the transitional arrangements would not impose new reporting requirements on schemes. However, it is difficult to see how individuals could carry out the necessary calculations for 2015/16 without some further information from their pension providers.

Looking ahead to 2016/17, those above £110,000 in 'threshold income' and expecting to be in the £150,000 to £210,000 band for 'adjusted income' (which includes pensions savings) are unlikely to know what their annual allowance for the tax year is until that year has ended (particularly where bonuses are paid towards the end of the tax year). By then it will be too late to vary their pensions savings. They may find that their annual allowance is lower than anticipated and be subject to a tax charge through self-assessment as a result.

Some employers might consider moving bonuses from late in the tax year to early in the (next) tax year, to give their employees more certainty over their income for the tax year and potentially enable them to plan around a more stable annual allowance estimate. Any such proposals would need to be considered in the context of the anti-avoidance provisions outlined above.

For those expecting to have an adjusted income in excess of £210,000 from 2016/17, the annual allowance position is more certain, but pensions savings above £10,000 are likely to be subject to a charge through self-assessment (or, on member request, 'scheme pays)', unless the individual has unused annual allowance to carry forward from previous years.

Completing the calculations likely to be necessary for self-assessment will be difficult. We suspect the information requirements will need amendment and employers and trustees may wish to go further than the statutory minimum each year. It remains to be seen what information will need to be included on Pension Savings Statements and which members will need to receive these (given that schemes are unlikely to have sufficient information on wider income to calculate the tapered annual allowance for all members).

Before then consideration should be given to communicating the anticipated changes in advance to reduce risk of unexpected tax bills arising as a result of employer sponsored pensions savings. Such consideration could be extended to cover tax efficiency of various options, which we cover in the following section.

For some individuals, the resulting charges will be significant. For example, a £30,000 reduction in annual allowance for 2016/17 would mean that a 45% tax payer with an input of £40,000 to pensions would face an additional £13,500 charge if no changes to their benefits package were made.

It is likely that more individuals will seek to use 'scheme pays' to meet the charge, resulting in adjustments to scheme benefits and additional administrative complexity.

It is possible that changes will be made to the provisions of the Bill as it passes through Parliament after the summer recess.

Wider context

The changes to the annual allowance provisions outlined above are being introduced against a background of wider changes to pensions taxation.

In particular, the lifetime allowance is being reduced from £1.25M to £1M from 6 April 2016 and the government is actively considering other changes.

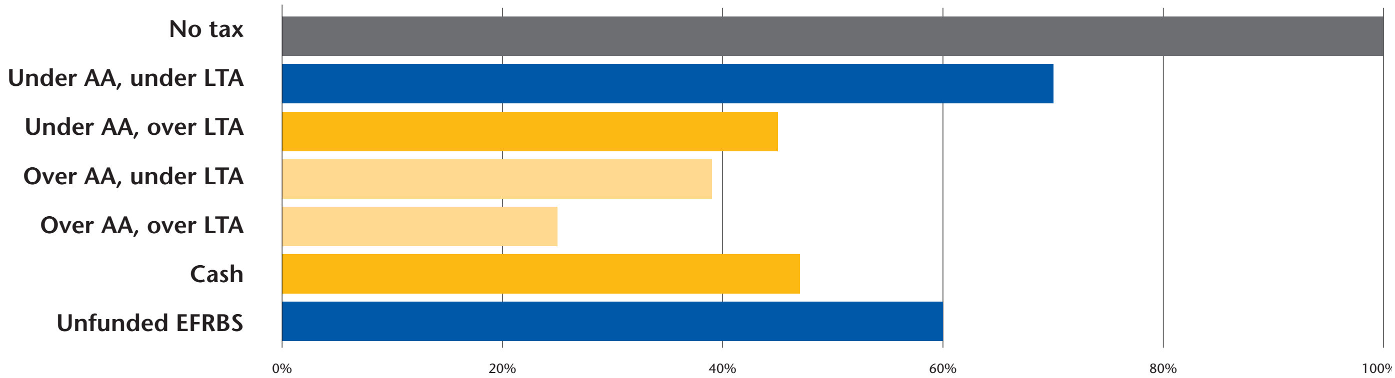
The reduced lifetime allowance will be accompanied by two forms of protection. HMRC's Newsletter 70 confirmed that these would have broadly the same conditions as those made available in 2014 when the lifetime allowance was last reduced:

- A fixed protection, allowing an individual's lifetime allowance to be maintained at £1.25M provided no benefit accrual occurs on or after 6 April 2016, and
- An individual protection, allowing individuals with pensions savings valued at over £1M on 5 April 2016 to have a personal lifetime allowance equal to this value (capped at £1.25M) without any prohibition on further benefit accrual.

Full details are expected over the summer. One positive piece of related news is that, after a series of reductions, the Government has indicated that the lifetime allowance will be increased in line with inflation from April 2018.

The reductions to annual allowance and lifetime allowance are significant. Pensions savings which exceed one or more of these thresholds may be inefficient from a tax perspective. The table below shows how much an employee receives post-tax for every £100 of (pre-tax) employer spend under various scenarios.

Tax efficiency for 45% tax payer now, 40% in retirement



For an individual paying 45% tax now and expecting to pay 40% tax in retirement, additional pensions savings that would lead to either the annual allowance or the lifetime allowance charge being payable are likely to be less tax efficient than simply paying the individual a cash alternative. Although taxed on receipt, cash could, for example, be invested in an ISA or other tax advantaged savings vehicle available to the individual.

Where the annual or lifetime allowance is an issue, unfunded EFRBS (Employer Financed Retirement Benefit Schemes) appear attractive from a tax perspective. Such arrangements involve the employer promising to pay employees an income in retirement but without funding the promise in advance. This would be free of National Insurance contributions if the legislative conditions are satisfied and, generally, also be taxable as income at a lower marginal rate than applied whilst the individual was still employed. However, the Budget announcement also indicated that the Government intends to consult on tackling the use of these arrangements to obtain a tax advantage in remuneration. The outcome of this could be that unfunded EFRBS become less attractive.

The Budget also announced a much wider consultation on pensions tax relief, aimed at strengthening the incentive to save. This could lead to more fundamental changes to pensions tax in future, based on the principles of simplicity, transparency, greater personal responsibility and sustainability. It remains to be seen what further changes this could lead to – the consultation notes that the consensus may be that no (further) change is needed but also refers to possible fundamental changes, such as moving from an "exempt-exempt-taxed" system, where tax is applied when pension payments are made, to a "taxed-exempt-exempt" system which would apply tax earlier, at the point at which contributions are made. No timescale is given for implementing any potential change.

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