

Budget – pension implications

In his Budget statement on 22 April 2009 the Chancellor of the Exchequer announced the following changes to tax rates and allowances for taxpayers with income over £100,000:

- from 2010/11 the basic personal allowance for income tax will be gradually reduced to nil for individuals with “adjusted net incomes” above £100,000;
- from 2010/11, there will be an additional higher rate of 50 per cent for taxable income above £150,000;
- from 2011/12 higher rate tax relief for individuals with an annual income of £150,000 or more will be tapered away so that for those earning over £180,000 relief will be worth 20 per cent;
- from 22 April 2009 there will be a new special annual allowance charge for those whose “relevant income” is £150,000 or higher who change their normal ongoing regular pension savings and their total pension savings exceed £20,000; and
- the measures includes new powers to vary the income tax rates for the charges that apply to registered pension schemes.

These changes replace the announcements made at the 2008 Pre-Budget Report. The reduction of personal allowances affects those with incomes over £100,000 and the new tax rate affects those with incomes over £150,000.

As announced at the 2008 Pre-Budget Report, the lifetime allowance will be maintained at the 2010/11 level of £1.8 million for a further five years, up to and including 2015/16. The annual allowance will also be held constant at £255,000 over the same period.

The HM Treasury document “Budget 2009 – Building Britain’s Future - Economic and Fiscal Strategy Report and Financial Statement and Budget Report - April 2009” contains the following statement:

Pensions tax relief

5.90 Tax relief, estimated to be worth around £30 billion in 2007-08, is provided on pension contributions to support pension saving and help individuals produce an income in retirement. This represents an important component of the Government’s support for pension saving among low and middle-income earners. In 2006 the Government introduced a new simplified tax regime, responding to criticism that the tax regime for pension saving had become so complex that it was discouraging saving. In reforming the regime the Government sought to strike a balance between the interests of pension savers and the interests of the wider taxpayer. Seeking to achieve this, the Government maintained tax relief at the marginal rate but set two limits – a lifetime allowance, currently standing at £1.75 million, and an annual allowance currently standing at £245,000 or 100 per cent of income whichever is the lower.

5.91 Those on highest incomes benefit disproportionately from this relief, and the personal tax changes announced in this Budget would increase the value of the reliefs given to individuals with the highest incomes. This would exacerbate the current situation whereby in 2008-09 individuals with income over £150,000 represented 1.5 per cent of pensions savers, yet received a quarter of all tax relief on contributions (£6.1 billion). This amounted to an average of £27,000 per person, an amount in excess of median earnings, and compares with £1,000 for people who pay income tax at the basic rate.

5.92 The 2008 Pre-Budget Report announced that the Government would maintain the lifetime allowance at £1.8 million for five years up to and including 2015-16. To ensure fairness, affordability and sustainability of tax reliefs, Budget 2009 announces that, in addition, from April 2011, tax relief on

pension contributions will be restricted for those with incomes of £150,000 and over. From that level of income, the value of pensions tax relief will be tapered down until it is 20 per cent for those on incomes over £180,000, making it worth the same for each pound of contribution to pension entitlement as for a basic rate income taxpayer. This restriction applies to all contributions, including employers', but employers will continue to receive full relief on their contributions into employees' pensions through corporation tax and NICs.

5.93 *The Government will consult business, pension fund trustees, the insurance and pensions industries, and other stakeholders to ensure that defined benefit pension schemes are treated fairly in relation to defined contribution pension schemes and personal pensions. It will want to arrive at the most appropriate method of valuing pension benefits of those with over £150,000 in defined benefit pension schemes and of valuing the related employer contributions. The Government will use this consultation to engage with stakeholders to introduce the new system in a way that minimises administrative burdens.*

5.94 *Given the importance of consulting on this measure, introduction before 2011-12 would be inappropriate. This means that, in the absence of any further changes, it would be possible for individuals to take advantage of the pensions tax relief while it is still available to them at the higher rate by making substantial additional pension contributions prior to the restriction taking effect. The Government's assessment is that unless it takes action significant revenues would be at risk over the two years before implementation. In anticipation of the change, the Government is therefore including legislation in this year's Finance Bill to prevent forestalling in this way whilst permitting individuals to continue to receive tax relief at the higher rate on the higher of £20,000 or their normal pattern of contributions. This legislation will apply with effect from 22 April 2009. Those who have never earned in excess of £150,000 a year are unaffected, as are those who continue with their regular, at least quarterly, pattern of contributions or normal benefit accrual.*

5.95 *Following changes to the personal tax system, the Government will consider consequential changes to pension tax charges which are designed to recover the tax relief provided in certain circumstances. Pension tax charges apply, for example, when allowances are exceeded and in connection with unauthorised payments. The Government will provide details in the 2009 Pre-Budget Report.*

The following information is based on [guidance on the HMRC website](#). The guidance, in turn, is based on draft legislation which may be amended as it goes through the Parliamentary process. HMRC point out that the guidance itself is, therefore, draft and may need to be amended to reflect any such changes.

Removal of basic personal allowance

This change applies from **6 April 2010** and only affects those with "adjusted net income" over £100,000 in 2010/11. Those with "adjusted net income" of £100,000 or below will be unaffected by the changes.

For those who are affected, their personal allowance will be reduced by £1 for every £2 that their income exceeds £100,000 until the personal allowance is reduced to Nil. This is instead of the two-stage reduction announced at the Pre-Budget Report.

The point at which the personal allowance is fully reduced will depend on the level of the personal allowance for 2010/11.

“Adjusted net income”¹ is calculated in a series of steps. The starting point is “net income” which is the total of the individual’s income subject to income tax, reduced by the grossed-up amount of the individual’s Gift Aid contributions and the grossed-up amount of the individual’s pension contributions which have received tax relief at source. The final step is to add back any relief for payments to trade unions or police organisations deducted in arriving at the individual’s net income. The result is the individual’s adjusted net income.

Example 1 – restricted personal allowance and pension contributions

| | | | |
|-------------------|----------------|------------|------------------|
| Income | 114,000 | allowance | 6,475 |
| LGPS Conts (7.5%) | <u>8,550</u> | | |
| | 105,450 | | |
| Limit | <u>100,000</u> | | |
| Excess | <u>5,450</u> | restrict ½ | <u>2,725</u> |
| | | Allow | 3,750 |
| Income | 105,450 | | |
| Allowance | <u>3,750</u> | | |
| Chargeable | 101,700 | | |
| | 37,400 x 20% = | | 7,480.00 |
| | 64,300 x 40% = | | <u>25,720.00</u> |
| Tax due | | | <u>33,200.00</u> |

Example 2 – restricted personal allowance and pension contributions

| | | | |
|-------------------|----------------|------------|------------------|
| Income | 122,160 | allowance | 6,475 |
| LGPS Conts (7.5%) | <u>9,162</u> | | |
| | 112,998 | | |
| Limit | <u>100,000</u> | | |
| Excess | <u>12,998</u> | restrict ½ | <u>6,499</u> |
| | | Allow | Nil |
| Income | 112,998 | | |
| Allowance | <u>0</u> | | |
| Chargeable | 112,998 | | |
| | 37,400 x 20% = | | 7,480.00 |
| | 75,598 x 40% = | | <u>30,239.20</u> |
| Tax due | | | <u>37,719.20</u> |

Higher rate tax charge of 50 per cent for taxable income above £150,000

This change applies from **6 April 2010**. From 2010/11 there will be 3 main rates of income tax:

- the basic rate (20%),
- the higher rate (40%), and
- a new additional rate (50%).

The new additional rate of tax will only apply to the amount by which someone’s income for 2010/11 exceeds £150,000 and this replaces the 45% rate announced at the Pre-Budget Report that would have applied from 2011/12.

¹ See definition in section 58 of the Income Tax Act 2007

The following example is for the tax year 2010/11 but uses the 2009/10 figure of personal allowance and basic rate band. No account has been taken of any effect which the proposed changes to tax relief on pension contributions might have (see the next heading below).

Tax due will be collected in the usual way through a combination of PAYE deductions during the year and payment through Self Assessment.

Example 3 – 50% rate and pension contribution

| | | | |
|-------------------|-----------------|------------------|---------------|
| Income | 170,000 | allowance | 6,475 |
| LGPS Conts (7.5%) | <u>12,750</u> | | |
| | 157,250 | | |
| Limit | <u>100,000</u> | | |
| Excess | <u>57,250</u> | restrict ½ | <u>28,625</u> |
| | | Allow | Nil |
| Income | 157,250 | | |
| Allowance | <u>0</u> | | |
| Chargeable | 157,250 | | |
| | 37,400 x 20% = | 7,480.00 | |
| | 112,600 x 40% = | 45,040.00 | |
| | 7,250 x 50% = | <u>3,625.00</u> | |
| Tax due | | <u>56,145.00</u> | |

Tax relief for high earners to be tapered away

The Government intends from **6 April 2011** to restrict tax relief for individuals with an annual income of £150,000 or more. This restriction applies to all contributions, **including employers’**. Tax relief will be tapered away so that for those earning over £180,000 relief will be worth 20 per cent, the same as to a basic rate taxpayer. No detail on this has been published but the Government has stated that it wants to arrive at the most appropriate method of valuing pension benefits of those with over £150,000 in defined benefit pension schemes (such as the LGPS) and of valuing the related employer contributions. It has promised to consult on the practical implications and to engage with stakeholders to introduce the new system in a way that minimises administrative burdens.

New special annual allowance charge

In anticipation of the above intended new restriction on tax relief for high earners, the Government is introducing anti-forestalling measures effective from **22 April 2009** to restrict higher rate tax relief on pension contributions for individuals. The restrictions apply to people

- whose “relevant income” in a tax year (or any of the previous two tax years²) is or has been £150,000 or higher
- who change their normal ongoing regular pension savings on or after 22 April 2009, and
- whose total “pension savings” in a tax year (including any increases from 22 April 2009) exceed £20,000.

² So, for 2009/10, income for 2007/08 and 2008/09 will also be considered.

All three of the above conditions have to have been met for the special annual allowance charge to apply.

The introduction of the special annual allowance charge will remove, for those affected, the advantage to them of increasing their pension contributions in excess of their normal pattern.

The vast majority of pension scheme members will, of course, be unaffected by the proposed changes which only apply to individuals with "relevant income" of £150,000 or more. Of those people, only those who increase their "pension savings" may be affected, and even then, only if their overall annual "pension savings" are £20,000 or more, and if they make changes to their normal pattern of "pensions savings" or to the way in which pensions benefits accrue.

The special annual allowance, which is set at £20,000, sets an upper limit on the amount of additional "pension savings" for which full tax relief at the higher rates of tax can be given. Tax relief on additional "pension savings" above the amount of this allowance will, via the special annual allowance tax charge, be at the basic rate of tax only. The special annual allowance tax charge which restricts relief on additional contributions to basic rate is a charge on the individual, collected via their Self Assessment tax return. The rate of charge is the difference between the highest rate of income tax and basic rate (20% for 2009/10).

Scheme administrators and employers will not be involved actively in the administration of this.

The following is based on the information on the HMRC website but the Government has promised that it will consult on the practical implications.

What is "relevant income"?

Broadly, for the purposes of the special annual allowance, "relevant income" is

- total income subject to income tax (i.e. after deduction of LGPS pension contributions, AVCs, ARCs etc, where tax relief is given under the net pay arrangement),
- plus pension contributions and AVCs / ARCs made,
- less any normal deductions for reliefs (such as trading losses)
- less deductions for pension contributions and AVCs / ARCs but up to a maximum of £20,000,
- less any gift aid deductions

But in calculating "relevant income" any amount of employment income foregone by salary sacrifice in return for pension contributions³ or additional pension benefits must be added back if the agreement was put in place on or after 22 April 2009.

What are "pension savings"?

This is all of a scheme member's pension savings that receive UK tax relief and includes:

- savings in all registered pension schemes including
 - defined benefit schemes, and
 - money purchase schemes (also known as defined contribution schemes), and
 - contributions paid both by individuals and anyone on their behalf and by employers
- savings in non-UK pension schemes that benefit from UK tax relief

³ Salary sacrifice in return for pension contributions is not possible under the LGPS

The value of a member's pension savings (the pension input amount) in a specified period (the pension input period) is valued in a similar way to the existing annual allowance.

For money purchase arrangements (including AVCs), this generally means the total contributions, including any from the employer, paid in to the pension scheme during the pension input period.

For defined benefit arrangements, this means any increase in the value of the member's accrued rights during the pension input period.

Note: augmented membership granted by an employer under the LGPS does not appear to fit the wording above (i.e. pension savings that receive UK tax relief) and so would appear not to be included. However, an employer might, for example, grant the augmented membership to offset the effect of some of the Budget's proposed tax changes, and this could potentially be seen by HMRC as a forestalling measure. The Secretariat is of the view, therefore, that it will be necessary to clarify how augmented membership should be treated.

What is the pension input period?

The pension input period for the special annual allowance will always be the tax year. This differs from the pension input period for the existing annual allowance (which in the LGPS currently ends on 31st March).

Why cannot the input periods be the same as for the annual allowance?

If the pension input period was not aligned to the tax year, this would allow individuals to have three input periods covering two tax years, and they would therefore be able to put in an additional £20,000 over that intended.

So, specifying that the pension input period for the special annual allowance will always be a tax year prevents double dipping e.g. someone putting in, for example, £11,000 in year ending 31 March 2010 and a further £10,000 before the 5 April 2010. A strict reading of the LGPS regulations would not permit this within the scheme as contributions have to be from monthly pay. But if a member tried to use an outside vehicle there would be a tax charge on this extra saving if the pension savings in the pension input period to 5 April exceeded £20,000.

What are normal, ongoing, regular pension savings?

The special annual allowance will apply only to increases to normal, ongoing, regular pension savings made on or after 22 April 2009. Normal, ongoing regular pension savings will be known as 'protected pension inputs'.

If the regular pension contributions of a member of a scheme provided by the employer go up only because the member has had a pay rise or a promotion, these will be 'protected pension inputs'.

For members of a final salary arrangement, all their pension savings in the final salary scheme will be a 'protected pension input' provided that the way their benefits are calculated under the scheme does not change on or after 22 April 2009.

If a member has a money purchase arrangement, the 'protected pension input' will be:

- the annual amount of their total contributions (including any employer contributions) to the arrangement providing that the contributions were made at least quarterly before 22 April 2009, plus
- any increase in the contributions that was agreed before 22 April 2009

If the member increases their contributions but the increase was not agreed before 22 April 2009, the increase will not be a 'protected pension input' and will be tested against the special annual allowance. Pension input amounts that are tested against the special annual allowance are called 'total adjusted pension input amounts'. These will be pension input amounts that were made only in the 2009/10 or 2010/11 tax years but they will not include 'protected pension input' amounts.

Example 4 – No liability to special annual allowance charge

G is in a final salary scheme on 22 April 2009 which pays her a pension of 1/60 of her salary for each year of service. At 6 April 2010 her salary after 5 years of service is £210,000 and by 5 April 2011 it has risen to £230,000. The rate at which she accrues her pension in the scheme does not change. This is therefore a 'protected pension input'.

If G's only pensions savings are in this final salary scheme, the value of this is calculated by working out the difference in the capital value of her pension savings between the start of the period and the end of the period.

The calculation is as follows:

Opening Value: £210,000 x 1/60 x 5 (years of service) x 10 (factor to give capital value) = £175,000

Closing Value: £230,000 x 1/60 x 6 (years of service) x 10 (factor to give capital value) = £230,000

Her 'protected pension input' is therefore £230,000 - £175,000 = £55,000. Although this is more than £20,000 she will not be liable to a special annual allowance charge as she does not have any 'non-protected pension input'.

[Note: The factor of 10 used to work out the value of rights in a defined benefit scheme is set in legislation i.e. section 234(4) of the Finance Act 2004.]

Pre 22 April 2009 (Budget day) Pension Savings

Any non regular pension savings from 6 April 2009 to 21 April 2009 will reduce the member's special annual allowance, but those non regular pension savings will not themselves be subject to the special annual allowance tax charge. Regular pensions savings will not be subject to the special annual allowance tax charge and also will not reduce the special annual allowance.

Increases in Pension Saving

The special annual allowance charge will affect individuals in a tax year if they have "relevant income" of £150,000 or more in that tax year or in either of the two previous tax years and increase the level of their annual pension savings.

This increase may be as a result of the individual making large additional pension contributions over and above their normal regular ongoing pension savings or by changes to the way their pension benefits are

calculated. This might be, for example, where the rate at which benefits accrue in a final salary scheme changes from 1/60 of salary per year to 1/40 of salary per year but where this only applies to certain members.

Exceeding the Special Annual Allowance

If a member exceeds the special annual allowance, then they will have to pay a special annual allowance charge on the excess at the difference between the top rate of tax and basic rate (20% for 2009/10). This will be collected through the member's Self-Assessment tax return.

The amount of the excess will be either:

- the increase in their pension savings - if their normal annual pension savings at 22 April 2009 plus any contributions made before 22 April 2009 were more than £20,000, or
- their total pension savings less £20,000 - if their normal annual pension savings at 22 April 2009 plus any contributions made before 22 April 2009 were £20,000 or less.

Example 5 – Liability to special annual charge

L is in a final salary scheme which will provide a pension of 1/60 of her salary for each year of service. At 6 April 2010 her salary after 5 years of service is £210,000 and by 5 April 2011 it has risen to £230,000.

L therefore has a pension input amount for 2010/11 of $((£230,000 \times 6/60) - (£210,000 \times 5/60)) \times 10 = £55,000$. Although this exceeds the special annual allowance of £20,000, there will not be a charge as the rate at which she accrues her pension in the scheme has not changed and is therefore a protected pension input.

L also makes a one-off payment in October 2010 of £60,000 to a personal pension scheme. Because her normal pension savings in her final salary scheme exceed £20,000, her special annual allowance is nil, so all of this additional contribution is a non-protected pension input and will be taxed. She will therefore be liable to tax on the full £60,000.

How will the increase in a member's pension savings be calculated if the member is in a final salary scheme and also pays additional contributions?

That depends on the type of arrangement the additional contributions are being paid to.

AVCs should be counted as a money purchase arrangement.

Additional contributions to purchase added years should be counted as part of a defined benefit arrangement.

The Secretariat assumes that ARCs should count as a money purchase arrangement (albeit that the contributions provide a defined benefit).

Does the Special Annual Allowance apply to members with Enhanced Protection?

If a member has relevant income of £150,000 or more, even if they have Enhanced Protection, they will still be subject to the special annual allowance if they increase their pension savings on or after 22 April 2009. In such cases there is a risk that enhanced protection status may be lost.

How does the special annual allowance interact with the existing annual allowance?

The new special annual allowance will run alongside the existing annual allowance. In practice this means that all increases in pension savings – ‘pension input amounts’ - will continue to be tested against the existing annual allowance in the usual way. However, any pension input amounts that represent new saving that is taken out by, or in respect of, an individual in the period starting with 22 April 2009 and ending on 5 April 2011 will be tested against the special annual allowance as well.

Pension input amounts that represent normal, regular, ongoing contributions, or benefit accruals, under arrangements that were in place before 22 April 2009 will not be tested against the special annual allowance. Such pension inputs are called ‘protected pension input amounts’. These pension input amounts will, however, continue to be tested against the existing annual allowance in the usual way.

Although unlikely, it is possible for an individual to be liable to tax under either the existing annual allowance or the new special annual allowance or under both. To ensure that tax relief is not recovered twice, where an individual exceeds both allowances, the special allowance charge will be reduced by the excess over the annual allowance.

Further details

Full details on [tax relief on pension contributions](#) and a [technical guide](#) can be found on the HMRC website.

Income tax rates for the charges that apply to registered pension schemes

The tax rates for charges applying to registered pension schemes are generally linked to the highest rate of income tax. There are powers in Finance Act 2004 to vary the rate for several of the charges by Treasury Order, and the Finance Bill 2009 will include legislation extending that power to the rates for the other charges, again through secondary legislation. For example, the special allowance charge for 2009/10 is set at 20% (the difference between higher rate and basic rate). When the 50% additional rate comes in for 2010/11, the Government might decide that the special annual allowance rate should go up 30%.