

MERCER



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A photograph of a business meeting. A man in a light purple shirt and tie is pointing at a large pie chart on a screen. Other people are blurred in the foreground and background, suggesting a collaborative work environment. The chart has several segments in various colors like blue, yellow, and orange.

# Reflecting on the Finance Act 2009 – pensions, benefits and savings

## Considerations for employers

# Reflecting on the Finance Act 2009 – considerations for employers

In this document, we discuss the key issues emerging from the pensions, benefits and savings measures in the Finance Act 2009 and consider the effect they could have on employers and employees. The document's primary focus is high earners, i.e. those with incomes of £150,000 and over, as this is where the biggest impact will be felt.

Budget item	Detail	Issues to consider/ Impact on employers
<p><b>Changes to tax relief on pension contributions</b></p> <p>The removal of marginal tax relief on high earners' pension accrual will come into effect in the 2011/12 tax year.</p> <p>The anti-forestalling regulations came into immediate effect on 22 April 2009 and, with minor amendments, have been passed into legislation via the Finance Act 2009.</p>	<ul style="list-style-type: none"> <li>■ 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, tax relief on pension savings will be tapered down to 20% for those on incomes over £180,000.</li> <li>■ "Pension savings" will include both employer and employee contributions to defined contribution (DC) arrangements and any benefit accrual (calculated in a way that will be prescribed in legislation) in defined benefit (DB) arrangements.</li> <li>■ The Government will consult to determine the most appropriate way of valuing accrual in DB arrangements for this purpose and to minimise any administrative burden.</li> <li>■ To discourage individuals affected by the change from increasing their contributions or benefits before April 2011, new anti-forestalling legislation was brought in with immediate effect. The legislation (broadly) will apply a <i>special annual allowance charge</i><sup>1</sup> to certain individuals who make (or their employers or other third parties make on their behalf) any pension saving that was not agreed to before 22 April 2009. It applies only to individuals:             <ul style="list-style-type: none"> <li>– whose <i>relevant income</i> is £150,000 or higher in the current or previous two tax years.</li> <li>– who increase their normal level of pension savings on or after 22 April 2009.</li> <li>– whose <i>total adjusted pension input amount</i> is more than the <i>special annual allowance</i> over the tax year.</li> </ul> </li> </ul>	<p><b>Pension saving continues to be a tax-efficient means of remuneration for the vast majority of employees, including many of those caught by the new tax regime:</b></p> <ul style="list-style-type: none"> <li>■ The new charges are the responsibility of the individual and do not directly impose costs on the employer (although they do so indirectly).</li> <li>■ High earners, concerned about their pension provision, may approach their employers for guidance. Employers could provide individuals with advice and information to help them determine whether they are likely to be affected by the anti-forestalling legislation or the post-2011 tax regime, and to enable them to make informed decisions.</li> </ul> <p><b>High earners may disengage from saving through a pension scheme, which may have a negative impact on the employer's attitude towards pension provision. Some pension arrangements will be able to mitigate the effects of the new charge better than others. For example, in some circumstances, DB scheme members may be able to use augmentations to make tax efficient contributions:</b></p> <ul style="list-style-type: none"> <li>■ The calculation of any <i>protected pension input amount</i> ignores the value of certain benefits (for example the rate of pension increases) so augmentations to these may still be tax-efficient.</li> <li>■ The <i>special annual allowance charge</i> is not applied to members of DB arrangements with at least 20 active or pensioner members in the year they take all their defined benefits from the scheme.</li> </ul> <p><b>Employers should consider the potential impact on their pension administration procedures and on other normal practices. If the post-2011 regime is implemented in the same way as the anti-forestalling provisions, then there should be no need for payroll changes. Some changes to employment contracts or remuneration may become less tax-efficient:</b></p> <ul style="list-style-type: none"> <li>■ The following practices could impose additional tax charges on affected employees and should be reviewed:             <ul style="list-style-type: none"> <li>– Some rule changes, depending on the pension scheme (e.g. increasing the contribution rate to a DC scheme, or an increase in the accrual rate affecting fewer than 50 active members in a DB scheme)</li> <li>– Some pension scheme restructuring (e.g. replacing one scheme with another, where fewer than 20 employees are affected)</li> <li>– Permitting sacrifice of annual bonus into pension scheme</li> </ul> </li> <li>■ Some individuals who are subject to the <i>special annual allowance charge</i> might prefer to receive a <i>contribution refund lump sum</i> in respect of any AVCs they made that are not treated as protected pension input amounts, rather than incur the charge. Employers should consider whether to facilitate payment of the refund.</li> </ul>

<sup>1</sup> Terms in italics are defined in the glossary at the end of this note.

## Reflecting on the Finance Act 2009 – considerations for employers, continued

Budget item	Detail	Issues to consider/ Impact on employers
<p><b>Changes to tax relief on pension contributions</b></p>	<ul style="list-style-type: none"> <li>■ Increases in pension contributions and accrual above the <i>special annual allowance</i> will be taxed at 20% through the individual's self-assessment tax return.</li> <li>■ Salary sacrifice agreements that are put in place on or after 22 April 2009 will not have the effect of reducing income for the purposes of this measure but will still produce an NI saving. Any pension contribution or increase in accrual resulting from a salary sacrifice or redundancy payment agreement that was agreed or completed by 22 April 2009 will be exempt from the <i>special annual allowance charge</i>.</li> <li>■ If on or after 22 April 2009 employees are enrolled into a pension scheme on special terms, or if they enter into a new agreement to pay AVCs, their benefits or AVCs could become subject to the <i>special annual allowance charge</i>.</li> <li>■ <i>Total adjusted pension input amount</i> is measured over the tax year, irrespective of the period used for the <i>annual allowance</i> test.</li> <li>■ Some of the detail is still unclear and HMRC has published guidance to indicate how it is likely to interpret it. The legislation includes provision for pension scheme contributions or accrual to be subject to the <i>special annual allowance charge</i>, where they are provided in a way that HMRC views as mainly intended to avoid the charge.</li> </ul>	<ul style="list-style-type: none"> <li>■ Employers with a group personal pension or stakeholder scheme may want to review their provider's ability to refund excessive employee contributions.</li> <li>■ High earners who are enrolled into new pension saving, or are granted special terms, could become subject to the <i>special annual allowance charge</i>.</li> <li>■ Individuals who have elected salary or bonus sacrifice may no longer benefit from this approach, leading to a reduction in NI savings.</li> <li>■ Members might need information from the scheme's administrator to determine whether they are subject to the <i>special annual allowance charge</i>, and to complete their self-assessment returns. Scheme administrators are not obliged to provide the information.</li> <li>■ The taxable part of redundancy payments will be included in the definition of <i>relevant income</i>, catching people who would not normally be "high earners".</li> <li>■ The period over which <i>pension input amounts</i> should be calculated for the <i>special annual allowance charge</i> might be different to the period used to test pension inputs against the <i>annual allowance</i>.</li> </ul> <p><b>Pension schemes may be more tax-efficient at income levels below £150k p.a.:</b></p> <ul style="list-style-type: none"> <li>■ It is not feasible to design pension provision exactly around different income groups but, provided the groups can be reliably identified, communication can be targeted appropriately.</li> <li>■ The employer may not be able to identify all those affected because of the definition of <i>relevant income</i>. Flexible pension provision, or flexible remuneration schemes, might enable employees to select the most appropriate arrangements.</li> </ul> <p><b>Other forms of remuneration may be more attractive than an occupational pension in certain situations:</b></p> <ul style="list-style-type: none"> <li>■ There will be cases where unfunded arrangements (an employer-financed retirement benefit scheme, or EFRBS), private medical care post-retirement, or cash are more tax-efficient than occupational or personal pension provision.</li> </ul>

## Reflecting on the Finance Act 2009 – considerations for employers, *continued*

Budget item	Detail	Issues to consider/ Impact on employers
<p><b>Introduction of new higher rate of income tax</b></p> <p>This change takes effect on 6 April 2010.</p>	<ul style="list-style-type: none"> <li>■ There will also be a new higher rate of income tax of 50% for taxable income above £150,000 from 6 April 2010. Dividend income received by individuals in the new higher tax bracket will be also be taxed at a higher rate (the current rate of 32.5% will be increased to 42.5%).</li> <li>■ The Government will consider (likely to be in the autumn) how this change in the top income tax rate should be reflected in certain tax charges applicable to pensions, such as the <i>lifetime allowance</i> and <i>annual allowance</i> charges, as well as charges applying to <i>unauthorised payments</i>.</li> </ul>	<p><b>High earners may put pressure on employers to seek more efficient forms of reward. Top talent may be lost to more tax-efficient jurisdictions and employers may struggle to attract overseas talent. Employers may want to mitigate the risk of losing their high earners or failing to attract overseas talent by:</b></p> <ul style="list-style-type: none"> <li>■ Reviewing short- and long-term incentive plans to ensure that they still align with changing business priorities and deliver corporate objectives in the most tax-efficient way.</li> <li>■ Giving higher earners the opportunity to invest for gains rather than income since the tax rate on dividend income will become relatively penal, compared to tax on capital gains (which remains at a flat 18%).</li> <li>■ Restructuring individual arrangements (e.g. reviewing the timing and form of bonus payments) to optimise corporate spend on remuneration, where appropriate in the context of strategic planning across different geographies.</li> <li>■ Providing tax-efficient all-employee share plans and approved option grants.</li> </ul>
<p><b>Changes to personal tax-free allowance</b></p> <p>This change takes effect on 6 April 2010.</p>	<ul style="list-style-type: none"> <li>■ From 6 April 2010, the personal tax-free allowance will be withdrawn at the rate of £1 for every £2 of income above £100,000, so that for incomes above about £113,000 it will disappear completely. The effective marginal tax rate for this band of earnings will be 60%. "Income" for this purpose is, broadly, all income subject to tax less trading losses, gross pension contributions and charitable donations.</li> </ul>	<p><b>Compensation, benefit and incentive plans taking individuals into this band of earnings will be very tax-inefficient, which may lead to lack of appreciation of reward. Individuals will be concerned that their pay is provided tax-efficiently:</b></p> <ul style="list-style-type: none"> <li>■ Flexible benefit and remuneration arrangements enable employees to adjust their income and savings patterns depending on their circumstances.</li> </ul> <p><b>Pension contributions and gift aid will be very efficient for those in the £100k – £113k band:</b></p> <ul style="list-style-type: none"> <li>■ Consider targeting communication and advice at those in, or likely to be in, the critical band of employees.</li> <li>■ Provide support to enable them to make informed decisions.</li> </ul>

# A round-up of other Budget changes

Budget item	Detail	Issues to consider/ Impact on employers
<p><b>Changes to Basic State Pension</b></p> <p>These changes take effect on 6 April 2010 and 6 April 2011.</p>	<ul style="list-style-type: none"> <li>The Basic State Pension will, as previously promised, increase by 2.5% from April 2010, even if the annual RPI change to September 2009 is, as expected, negative.</li> <li>People of working age who spend at least 20 hours a week caring for grandchildren or other family members aged 12 or under will, from April 2011, earn credits towards their Basic State Pension.</li> </ul>	
<p><b>Changes for those entitled to Pension Credits</b></p> <p>This change will take effect in November 2009.</p>	<ul style="list-style-type: none"> <li>The amount of savings to be disregarded in determining entitlement to the means tested Pension Credit will increase from £6,000 to £10,000 in November 2009. There will also be a campaign to encourage Pension Credit recipients to ensure that they receive savings income tax-free.</li> </ul>	<p><b>The Pension Credit deters low earners from joining pension schemes; an increase in the savings threshold will mean more people are likely to be eligible for Pension Credit:</b></p> <ul style="list-style-type: none"> <li>Employees may seek support in determining whether they should join the pension scheme.</li> </ul> <p><b>Pension provision for low earners must be considered in the context of the proposed employer obligation to auto-enrol employees who meet certain pay and age criteria into pension schemes. Low-paid employees are often those most likely to opt out of, or not join, an employer's pension arrangements:</b></p> <ul style="list-style-type: none"> <li>Existing arrangements that are to be used to meet the new auto-enrolment arrangements might not meet the requirements for a minimum quality of benefit (broadly, a minimum contribution test in a DC scheme and a minimum accrual test in a DB scheme).</li> <li>Employees may not be currently auto-enrolled into a pension scheme and may have to opt in. Membership under auto-enrolment is normally much higher.</li> <li>Increased cost of auto-enrolment may affect sustainability of existing arrangements.</li> </ul>
<p><b>Increase in annual limit for ISA investments</b></p> <p>With effect from 6 October 2009, the ISA limit is increased for those aged 50 or over. This higher limit applies to all with effect from 6 April 2010.</p>	<ul style="list-style-type: none"> <li>The annual limit for ISA investments will increase to £10,200 (of which up to £5,100 may be invested in a cash ISA) from 6 April 2010. Individuals over age 50 will, from 6 October, also be allowed to take advantage of this increase for the current tax year.</li> </ul>	<p><b>More generous relief may mean that a corporate ISA could be more widely considered by employers. The design of a corporate ISA should take account of the workforce, the type of business and other employer savings plans (e.g. SAYE), noting that:</b></p> <ul style="list-style-type: none"> <li>This may result in lower usage of AVCs.</li> <li>The degree of integration with other benefits needs to be considered, as well as any constraints imposed by the existing benefit programme.</li> </ul>

## A round-up of other Budget changes, *continued*

Budget item	Detail	Issues to consider/ Impact on employers
<p><b>Increase in statutory redundancy pay</b></p> <p>This change is expected to take effect on 1 October 2009.</p>	<ul style="list-style-type: none"> <li>■ Statutory redundancy pay will increase from £350 to £380 per week.</li> </ul>	
<p><b>Savings Gateway</b></p> <p>This change will take effect on 6 April 2010.</p>	<ul style="list-style-type: none"> <li>■ This is a special savings scheme for eligible low-paid people where the Government will match contributions to savings for low earners. Savings gateways have been trialled in some parts of the UK and are to be extended nationally from 6 April 2010.</li> </ul>	<p><b>Communication material will need to make employees aware of this plan as an alternative:</b></p> <ul style="list-style-type: none"> <li>■ Lower earners may be better served by using the Savings Gateway than an employer's pension or savings scheme.</li> <li>■ Alternative savings schemes provision may look like an incentive to opt out of a pension arrangement, following the proposed introduction of auto-enrolment, so care should be taken to ensure other savings schemes offered are a genuine alternative.</li> <li>■ Employees will need support to make an informed decision between pension and other forms of savings.</li> </ul>

# Glossary

**Annual allowance** – the maximum pension scheme contribution or benefit accrual that individuals can make themselves, or have employers or other third parties make on their behalf, during a pension input period without incurring tax charges on their pension saving.

**Contribution refund lump sum** – in certain circumstances, it is possible for trustees to refund member contributions. The Finance Act 2004 has been amended so that this can occur if the member has paid AVCs (other than those treated as protected pension input amounts) but at the end of a tax year it becomes apparent that the member will be subject to the special annual allowance charge. Employer contributions are not refundable.

**Lifetime allowance** – the maximum pension saving individuals can make over their lifetime without incurring additional tax charges.

**Pension input amount** – in money purchase arrangements, this is the contribution paid to the scheme during the year by, or on behalf of, the member. In DB schemes, it is the difference between the pension accrued at the start and the end of the year, multiplied by 10.

**Pension input period** – the period over which the pension input amount is measured. For the annual allowance, the period can be scheme specific; for the special annual allowance, the period must be the tax year.

**Protected pension input amount** – these are (broadly) pension input amounts accrued under an arrangement entered into before 22 April 2009, where there have been no changes to the rules governing the rate of accrual or contribution. Where the pension input amount is in respect of DC contributions, these must be made at least quarterly.

**Pre-22 April pension input amount** – this is a pension input amount accrued in respect of service from 6 April 2009 to 21 April 2009 inclusive.

**Relevant income** – individuals with relevant income above £150,000 are subject to the special annual allowance charge. Relevant income is broadly calculated as:

- Income subject to income tax less any normal deductions
- Plus any pension contributions paid under net pay arrangements
- Plus any income sacrificed in return for pension scheme contributions or benefits, if the arrangement was agreed on or after 22 April 2009
- Less any pension contributions paid, up to a maximum £20,000
- Less any gift aid donations.

**Relevant refunded amount** – if a contribution refund lump sum has been paid to a member in respect of non-protected pension inputs, its affect on the pension input amount should not incur a special annual allowance charge. A provision to deduct the relevant refunded amount in the calculation of the total adjusted pension input amount addresses this.

**Special annual allowance** – the special annual allowance is normally £20,000 less any protected pension input amount and any pre-22 April 2009 pension input amount. It has a minimum value of zero. In limited circumstances where individuals have irregular money purchase contributions, the special annual allowance before deductions could be increased up to £30,000.

**Special annual allowance charge** – if an individual has relevant income over £150,000 and total adjusted pension input amount that is greater than the member's special annual allowance, then a charge of 20% is levied. It is applied to the excess of the total adjusted pension input amount over the member's special annual allowance and is collected via the individual's self-assessment form.

**Total adjusted pension input amount** – calculated over a tax year, this is the aggregate of a member's pension input amounts less any protected input amounts, relevant refunded amount and any pre-22 April pension input amounts.

**Unauthorised payments** – the Finance Act 2004 permits pension schemes to make certain payments to members and to the employer (authorised payments) without incurring additional tax charges. Other payments (unauthorised payments) can incur tax charges.

**For more information please speak to your usual Mercer consultant or contact Deborah Cooper on 020 7178 7184.**

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