

# TAX Pensions



## Simplifying the Taxation of Pensions

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The 'simplification' of pension taxation from 6 April 2006 ('A-Day') has been marred by the welter of changes since (including some announced and legislated, but dropped before implementation); and is to be further changed from 6 April 2011, on the basis of draft clauses published 14 October 2010.

### Lifetime limit and Annual limit

There is a **lifetime limit** on the amount of pension saving that can attract favourable tax treatment, complemented by an **annual limit** on tax-free inputs to an individual's pension arrangements.

The **lifetime limit** was initially set at £1.5m, increased to £1.6m from 6 April 2007, £1.65m from 6 April 2008, £1.75m from 6 April 2009 and £1.8m from 6 April 2010. In the Pre-Budget Report on 24 November 2008 the Chancellor announced that the lifetime limit and annual limit would remain unchanged for the five years to 5 April 2016. However, the Coalition Government proposes that instead the lifetime limit be cut back to £1.5m from 6 April 2012.

The **annual limit**, which applies to inputs in 'pension input periods' ending in a tax year, was initially set at £215,000, increased to £225,000 for 2007/08, £235,000 for 2008/09, £245,000 for 2009/10 and £255,000 for 2010/11. However, the draft clauses published on 14 October 2010 reflect proposals that the annual limit from 6 April 2011 should be cut to £50,000, with transitional rules for pension inputs before 14 October 2010 in pension input periods beginning in 2010/11 but ending in 2011/12. Furthermore the annual limit is enhanced by any amount by which pension inputs in pension input periods ending in the three preceding tax years fall short of £50,000 (provided the individual is a member of a registered pension scheme in that year). Where the preceding years are 2008/09, 2009/10 or 2010/11 pension inputs are calculated as they would be if the rules from 6 April 2011 applied to defined benefit schemes, and any shortfall in one of those years is not offset against any excess (of inputs over £50,000) in 2009/10 or 2010/11. Otherwise, any shortfall is 'used up' (that is, set off against) any excess in a subsequent year.

### EXAMPLE

#### Pension inputs in pension input periods ending in

2008/09	£30,000
2009/10	£60,000
2010/11	£45,000

Annual allowance for 2011/12 = £50,000 + £20,000 (shortfall 2009/10) + £5,000 (shortfall 2010/11) = £75,000

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### Pension inputs in pension input periods ending in

2011/12	£55,000 [shortfall against the annual allowance of £75,000 is therefore £20,000]
2012/13	£85,000 [which exceeds the annual allowance of £50,000 + £20,000 by £15,000]
2013/14	£45,000 [shortfall against the annual allowance of £50,000 is £5,000]

Annual allowance for 2014/15 = £50,000 + £5,000 = £55,000

The term 'pension inputs' embraces contributions to personal pension policies and retirement annuity contracts, contributions met by deduction from pay, employers' contributions to defined contributions schemes and benefits accrued in defined benefits schemes met by employers.

Each pension arrangement has a 'pension input period' ('PIP'). The first PIP ends on the first anniversary of its beginning, unless an earlier date is nominated. Successive PIPs (which may not exceed 12 months) end on each anniversary of that first end date unless, again, an alternative date is nominated – which must be in the tax year following that in which the preceding PIP ended.

*It is clear that those with pension arrangements whose current PIP ends after 5 April 2011 might find it beneficial to nominate 5 April as the date at which the first, and therefore successive, PIP ends. It has to affect all PIPs because of the prohibition on successive PIPs ending in the same tax year.*

*One change contained in the proposals published on 14 October 2010 means that, probably with effect from Royal Assent to the Finance Act 2011 a nomination, cannot be retrospective. Thus, it will then be too late to take action to avoid a PIP beginning in 2010/11 and ending in 2011/12*

### Income tax relief

Income tax relief is available on all contributions made by or for an individual under 75 (other than any made by his employer) up to a maximum of the individual's earnings or, if more £3,600.

Schemes established by employers may continue to use the net pay arrangements. Contributions to retirement annuity policies are payable gross. Contributions to other pension schemes attract basic rate tax relief by deduction at source, with higher rate taxpayers claiming relief at the excess through their self-assessment tax return.

Employers will get tax relief on contributions made in respect of their employees, even if the employee is over 75, save that, where made by a trader, they will have to satisfy the 'wholly and exclusively' test.

Employees are not taxable on their employer's contributions or benefits accrued under a defined benefit (final salary) scheme as a benefit; save where the **annual limit** is exceeded, as explained below.

*But see later regarding the intended restriction of tax relief to basic rate for excessive pension inputs in 2009/10 and 2010/11.*

Different rules apply to people who are not resident and ordinarily resident in the UK, with some relief available where in the last six years they have either been resident and ordinarily resident in the UK or have had UK chargeable earnings.

### Exceeding the Annual limit

Anyone whose 'pension inputs' in pension input periods *ending in* a tax year exceed the limit for that year is liable to income tax on the excess, through their self-assessment tax return. For years up to 2010/11 any such excess is charged at 40%. From 2011/12 it is proposed that any excess would be charged at the individual's marginal rate. He or she would have had income tax relief on their contributions (or not been taxed where the contributions are by their employer).

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For years up to 2010/11 £10 of value is attributed to every £1 of defined benefit pension accrued, in valuing accrued benefits in a defined benefits scheme in the context of the annual limit. For 2011/12 et seq. the Government proposes this should be increased to £16.

For years up to 2010/11 the pension inputs in a year in which the individual becomes entitled to all the benefits from a pension arrangement or in which he dies are ignored. It is proposed that, from 6 April 2011, this will only apply to the year in which the individual dies or retires through severe ill health.

### Example

Adam has a self-administered personal pension scheme to which he has contributed £15,000 a month for some years. He pays on the 6th day of each month, his first contribution was on 6 April 2007. His income is in excess of £400,000, so the habitual nature of his contributions means that he is entitled to income tax relief at his top rate of 50% in 2010/11.

Adam's current pension input period ends on 6 April 2011. So, in the absence of a nomination his inputs in the PIP ending in 2011/12 will be £180,000. Of this total, £105,000 will have been before 14 October 2010 and £75,000 on or after that date. Transitional relief means that Adam's 'pre-announcement' contributions carry no tax liability but he will be charged tax at 50% on £25,000, being the excess of the later contributions over £50,000.

If Adam were to nominate 5 April 2008 as the end of his first PIP (ideally before 6 April 2011, otherwise before Royal Assent to the Finance Act 2011), so that his current PIP ends on 5 April 2011, he would avoid any liability on the last five monthly contributions to his pension arrangement, while not disturbing the tax position for earlier years.

### Forestalling charge

On 22 April 2009 the Chancellor announced that pension inputs after 5 April 2011 would only attract basic rate tax relief for those on 'high earnings'. Provisions were introduced to forestall attempts to enhance pension funds by extra contributions in 2009/10 and 2010/11. The Chancellor in December 2009 made the regime for 2009/10 even tougher, clarified the method to be adopted for 2010/11 and gave more details of very complicated proposals for 2011/12, although indicating that certain aspects remained open for consultation. The Government's conclusions following that consultation were announced on Budget Day, 24 March 2010.

However, following the General Election, the new Government took a fresh look at the position from 2011/12. Clauses reflecting their proposals were published on 14 October 2010.

In consequence there are different regimes for each of 2009/10, 2010/11 and 2011/12 (and subsequent years).

### 2009/10 and 2010/11

The forestalling provisions announced on 22 April 2009 were intended to confine tax relief to the basic rate on excessive pension inputs for those whose 'relevant income' in that year or either of the two preceding years was £150,000 or more. The Chancellor in the Pre-Budget Report in December 2009 dropped that threshold to £130,000.

The definition of 'relevant income' for both years is the same:

Income chargeable to tax, but adding back personal allowances and all the individual's own pension contributions save for the first £20,000, and adding any salary sacrificed under a salary sacrifice scheme made after 21 April 2009 or, in applying the £130,000 threshold, salary sacrificed under a scheme made after 8 December 2009.

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*Note that the whole of the amount chargeable on redemption etc of single premium life policies etc is included in income, ignoring the effect of top-slicing relief.*

Although for both these two years the intention is the same - to restrict tax relief to basic rate - the legislation for **2009/10** can result in a denial of *any* tax relief in exceptional circumstances. The restriction is achieved by imposing a '**special annual allowance charge**' on excess '**pension inputs**'.

The excess pension inputs is the excess of total pension inputs over whichever is the greater of -

- (i) those that are 'protected' (being monthly or quarterly inputs that were in existence before 22 April 2009) and
- (ii) £20,000 or, if more, but not more than £30,000, the average of the 'infrequent' (i.e. not monthly or quarterly) pension contributions made in the 3 years ended 5 April 2009.

The **special annual allowance charge** for **2009/10** is a stand-alone tax charge at 20% of the excess pension inputs.

For **2010/11** the **special annual allowance charge** is to be at such rate as will confine tax relief on the excess inputs to 20%.

Because the special annual allowance charge can apply despite the *current* year's relevant income being below £130,000, the method of calculation for 2009/10 can result in a special annual allowance charge where only basic rate tax relief has been obtained, therefore removing *all* tax relief on the excess inputs.

### Example

Margaret's relevant income in 2008/09 was £130,000.

Her income in 2009/10 is only earnings of £40,000.

Having just inherited a substantial sum, Margaret decides to make up her pension contributions to £33,525. Her personal allowance is £6,475 so she has no income tax liability

Her income tax liability for 2009/10 if no pension contributions were made would be £33,525 @ 20% = £6,705.

Tax relief on £33,525 pension contributions is therefore all at basic rate.

Her special annual allowance is £20,000, so the special annual allowance charge is 20% of £13,525 = £2,705, leaving Margaret with only £4,000 tax relief on £33,525 contributions.

The precipice nature of the 'special annual allowance charge' means that the effective tax rate on the slice of income that pushes an individual into vulnerability can be ridiculously high.

### Example

Sarah's relevant income in 2009/10 is £129,000 [and was less in the previous two years].

Her pension inputs are £50,000, all after 21 April 2009 and irregular.

The average of her pension inputs in the previous 3 years was £20,000 or less.

Suppose Sarah's income is increased by £1,000 to the threshold of £130,000.

Tax at 40% on the extra £1,000 income is £400,

But in addition a liability for the special annual allowance charge emerges at 20% on £30,000 [the excess of £50,000 over £20,000 allowance] = £6,000

So the total tax on the extra £1,000 income is £6,400.

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Fortunately, charitable gifts are deductible in arriving at relevant income. So, in this case, the well informed would have seen that a charitable donation of £800 net under gift aid made both before filing the 2010 tax return (and before February 2011) could extinguish the liability for the special annual allowance charge, as well as attract higher rate tax relief of £200.

### The lifetime limit

On drawing benefits the lifetime limit will apply. Subject to that limit, up to 25% of the "matured pension savings" may be drawn as a tax-free lump sum. The remainder must be drawn as an income subject to income tax. A single factor is adopted for valuing defined benefits against the lifetime allowance - 20:1 at all ages.

Where the pension funds are relatively small the whole fund may be taken as a lump sum, of which 75% will be taxable. For 2006/07 to 2010/11 this '**trivial commutation**' is available to those over 65 whose pension funds are no more than 1% of the lifetime limit, so currently £18,000. From 6 April 2011 it is no longer to be linked to the lifetime limit, but will remain £18,000.

If the pension fund exceeds the lifetime limit the excess is liable to a '**lifetime allowance charge**' at 25%, or 55% if drawn, but will not be subject to tax as income. To the extent an inflow exceeding the annual limit has contributed to the excess over the lifetime limit this remains unduly penal taxation, as no tax relief would have been given on that excess inflow.

It also follows that gains and income resulting in a pension fund being 'excessive' escape tax as they arise but can suffer tax - in the guise of part of the 'excess'- at up to 55%.

People in **serious ill health** who have a severely reduced life expectancy are to be able to draw the whole of their pension funds, if no more than the lifetime limit, as a tax-free lump sum.

### Drawdown

**Prior to 6 April 2011** a pension scheme member could draw as income, instead of buying an annuity, up to 120% of an equivalent annuity up to the age of 75 – '**drawdown**'. From the age of 75 the member could either buy an annuity or draw '**alternatively secured income**' ('**ASI**').

For 2006/07 the maximum income that could be taken in any year was 70% of that which could be generated by applying to the fund an annuity rate for a person of the member's gender aged 75. There was no minimum. From 6 April 2007 to 2010/11 the ASI is a minimum of 55% and a maximum of 90% of the annuity rate for a 75-year old. The minimum and maximum figures were to be reviewed annually. On the member's death before 6 April 2011 any remaining funds underlying the ASI are to be used first to provide dependants' pensions [surviving spouse or civil partner or child under 18]. If there are no dependants, any remaining pension fund would have revert to the scheme, where it might be re-allocated to provide pension benefits for other scheme members or pass to the member's estate [but, if death occurs after 5 April 2007, then suffering a deterrent 70% tax charge] or be paid to a registered charity. ASI could be converted to a guaranteed pension for life or an annuity at any time at the member's discretion.

If there are any left-over funds after the death of the member or that of his dependant (or when the dependant ceases to qualify as such, having attained the age of 18) which are not given to charity, there could be an **inheritance tax** liability. This is calculated by reference to the value of the left-over fund at the date of the relevant event; the tax being that additional amount which would have been payable had that value been added to the estate of the deceased member.

*On the basis of the draft clauses published 14 October 2010, however, on death after 5 April 2011, there is not normally to be an inheritance tax liability.*

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In the 'Emergency Budget' on 22 June 2010 the Chancellor announced a change in the rules, with at least a deferral of the need to buy an annuity until the age of 77 for those not yet 75. Then a much more comprehensive change was announced, to apply from 6 April 2011.

**From 6 April 2011** 'drawdown' for those under 75 and 'alternatively secured income' are both termed 'drawdown pension'. There is no obligation at all to buy an annuity at any age. The maximum income that may be withdrawn is 100% of the equivalent annuity [a figure to be reviewed every three years until age 75, annually thereafter], unless the member has a lifetime pension income of at least £20,000 a year, in which case there is no cap on the amount he may draw.

Inheritance tax will no longer be charged on drawdown pension funds except where pension scheme trustees have no discretion with regard to the distribution of lump sums after the member's death.

### Transitional position

#### Primary protection -

Where an individual had pension rights valued in excess of £1.5 million at A-Day, he or she could give notice of his intention to rely on that value by 5 April 2009. Values that are registered are expressed as a percentage of the statutory lifetime allowance. For example, for someone who had a fund of £2.25 million at A-Day, the percentage will be 150%. By expressing the A-Day value in percentage terms, the value will be automatically indexed in parallel with the increase of the lifetime allowance. When the pension vests, the individual can take benefits, in this example up to 150% of the value of the statutory lifetime allowance in that year, without incurring any tax liability under the recovery charge.

#### Enhanced protection -

There was an alternative approach for the protection of pre A-Day pension funds against the recovery charge. This is available for those who, before A-Day, stopped contributing to their pension funds. This is not restricted to individuals with pension values exceeding £1.5 million. Under this alternative approach all post A-Day increases in the value of pension funds and benefit rights accrued before A-Day are protected from the recovery charge. Notice of an intention to rely on this protection had to be given by 5 April 2009.

Anyone who has taken the alternative approach may resume active membership of a pension scheme any time before they reach age 75. For those who resume active scheme membership, protection from the recovery charge will be determined by their A-Day pension value. For those whose pension value did not exceed £1.5 million, their personal lifetime allowance will be 100% of the lifetime allowance. For those who registered pension values exceeding £1.5 million, their personal lifetime allowance will revert to the percentage of the lifetime allowance which corresponded to the value of their pre A-Day fund.

Those who registered funds in excess of £1.5 million at A-Day will also protect any tax-free lump sum entitlement over £375,000. After A-Day they can take the amount of the pre A-Day lump sum rights increased to the same extent as the increase in the lifetime allowance.

People who chose enhanced protection from the recovery charge can take 25% of the pension value vesting after A-Day as a tax-free lump sum.

At A-Day some members of occupational schemes, who had not registered for transitional protection, will have been entitled to a tax-free lump sum in excess of 25% of the value of their pension benefit. At vesting they will be able to take the tax free lump sum to which they were entitled at A-Day, increased to the same extent as the increase in the lifetime allowance to the date of vesting.

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Pensions already in payment at A-Day are treated as having used up part of an individual's lifetime allowance where, after A-Day, the individual has a new benefit coming into payment. The factor for valuing such pensions is 25:1. Where income is being drawn from a pension fund under an income drawdown arrangement, the annual level of the pension in payment is deemed to be the maximum permitted annual income determined at the most recent valuation of the member's fund.

**Fixed protection** is to be available from 6 April 2012 for those without existing protection and whose pension funds already exceed £1.5m then. Notice of the intention to rely on this has to be given to HMRC by 5 April 2012, and the protection is lost if there are pension inputs after 5 April 2012.

### Death benefits

On death before drawing pension benefits a scheme may pay a lump sum which is free of tax.

On death before 6 April 2011 while under 75 and receiving pension benefits the scheme may pay

- lump sums, taxable at 35%, of no more than the value of the vested funds used to provide the pension income less the sum of the pension payments paid before death, or
- taxable income benefits for survivors or dependants.

On death before 6 April 2011 and after age 75 the only benefits available to survivors or dependants are income benefits.

On death after 5 April 2011 while receiving pension benefits, regardless of age, lump sum benefits (as opposed to income benefits to survivors or dependants) are to be taxed at 55%.

As noted above, the draft clauses published 14 October 2010 indicate that there is not normally to be an inheritance tax liability on death after 5 April 2011.

### Employer-Financed Retirement Benefit Schemes (EFRBS).

**Unapproved Schemes - FURBS (funded unapproved retirement benefit schemes) and UURBS (unfunded unapproved retirement benefit schemes)** no longer receive tax-favoured status. They are now referred to as Employer-Financed Retirement Benefit Schemes (EFRBS).

As any future retirement provision made through the equivalent of unapproved pension schemes do not attract any specific tax privilege, amounts saved in any such scheme are not tested against the annual and lifetime allowances and the recovery charge does not apply to them. For unfunded schemes the value of the promise to pay a pension on retirement will not be taken into account when considering the annual allowance and will not be tested against the lifetime allowance. When benefits are paid out, whether by lump sum or pension, they will be fully subject to tax at the member's marginal rate.

- Contributions by an employer to an EFRBS will not result in a tax charge on the employee or be liable to NICs, but nor will the employer get any deduction for his contributions until benefits start to be paid to the employee.
- An EFRBS is subject to tax on its income and capital gains.
- Benefits paid out by the EFRBS will be liable to income tax within the general taxation provisions, subject to transitional protection.
- Benefits paid out by the EFRBS will not be subject to employers' or employees' NICs if the benefits are consistent with the general benefit rules for an approved scheme.
- An EFRBS has no inheritance tax-favoured status, subject to transitional protection.

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### Transitional protection

- A tax-free lump sum may be taken from an EFRBS if the scheme started before December 1993 and it has not been varied subsequently, or all of the scheme's income and gains have been taxable and no contributions have been made since 5 April 2006. Otherwise a lump sum is only tax-free to the extent that it doesn't exceed the amount of employer contributions made before 6 April 2006 and any employee contributions. In either case this is conditional on the employee having been taxed on the employer's contributions as they were made.
- Amounts in a FURBS at 5 April 2006 will continue to retain their previous inheritance tax treatment. Where additional contributions are made after 5 April 2006, funds will be apportioned.
- Any UURBS in place on the day before 5 April 2006 could have been consolidated and rolled into a registered scheme before **6 July 2006**. The increase in value of benefits in the registered scheme caused by the incorporation of the UURBS did not count towards the annual allowance but will be tested against the lifetime allowance when vested.
- A UURBS consolidated and rolled into a registered scheme at any other time will count towards both the annual allowance and the lifetime allowance.
- Previously approved schemes had the choice of opting out of the new regime at 5 April 2006. Where they did so, the new regime imposed a 40% tax charge on fund assets immediately before opt-out. This charge will recover the tax relief given originally. Funds withdrawn from the scheme after 5 April 2006 will be subject to tax and NIC, with no entitlement to a tax-free lump sum.

### Surpluses

Because benefits will be unlimited (albeit with a varying tax burden), the concept of surplus falls away almost entirely in defined contribution schemes. However, a surplus could arise for defined benefit schemes. Department of Work and Pensions (DWP) rules will be relied on to determine when a surplus arises in a defined benefit scheme. When a surplus is paid to an employer, there is a tax charge of 35%.

### Investment

There is a single set of investment rules. They were to be simple, flexible and impose as few restrictions as are compatible with prudent standards. As originally envisaged, the new regime would, subject to DWP requirements, have allowed pension schemes to invest in all types of investments, including residential property. However, the Government, seemingly swayed by Press comments that misunderstood the tax position, announced in the Pre-Budget Report on 5 December 2005, that restrictions [in the form of draconian tax penalties] would be imposed on certain investments made by 'self-directed' pension schemes such as self-invested personal pension schemes (SIPPS). Those affected are investments made directly or indirectly in residential property or 'tangible moveables'. It is notable that this expression goes well beyond the words used in the December 2005 Pre-Budget Report, which referred to certain other assets such as fine wines, classic cars and art & antiques.

For all schemes, from A-Day

- there is a limit for shareholdings in the sponsoring employer and associated/connected companies of 5% of fund value.
- loans to members are not allowed.
- loans to employers, other than in the form of bonds issued on the open market, must
  - be secured as a first charge
  - on assets that are and will remain of at least equal value to the face value of the loan

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- have an interest rate at least equal to the Corporation Tax SA rate up to the normal due date
  - not last for more than 5 years
  - not be more than 50% of the value of the fund at the date the loan is taken out
  - be repaid either by equal annual instalments of capital or by equal annual instalments.
- scheme borrowing will be limited to 50% of scheme assets at the date the loan is taken out.

The **minimum retirement age** is 55 (subject to an exception for ill health retirement).

This would apply even to those such as certain professional sportsmen whose retirement age is lower than 50 currently. But the Government will allow people in pension schemes at A-Day with a low normal retirement age to keep their existing rights to take benefits early, but subject to two conditions

- the pension will be tested against a reduced lifetime allowance
- the full pension must be vested.

A reduction of 2.5% will be applied to the lifetime allowance for each year before 55 that the pension is taken. For example a pension taken at age 35 would reduce the lifetime allowance of that individual by 50%. The pension fund would therefore be valued against 50% of the prevailing lifetime allowance. 50% of the lifetime allowance would remain unused and could be carried forward for use in determining the amount of any further tax-privileged savings that could be built up.

The reductions in the lifetime allowance are not to apply to members of the armed forces and police and fire services Deferred and active pension scheme members at A-Day with a contractual right to draw a pension after 50 will have that right protected, so long as that right was extant at 10 December 2003.

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