

# Pensions tax changes announced

*Employees may face increased tax on income as a result of pensions tax changes*

*20 October 2010*

On 14 October 2010, the Government announced reduced annual allowance and reduced lifetime allowance for pensions savings

## What is the issue?

The reduced annual allowance and lifetime allowance will bring many more individuals than currently is the case within the scope of the tax charges. These changes will apply to all pension scheme members, whether they are in defined benefit or defined contribution pension arrangements and includes both occupational and personal pension schemes.

Most people affected will be those in defined benefit pension schemes, especially those in final salary schemes with long service or who receive large salary increases. It may also no longer be attractive to defer bonuses into defined contribution arrangements, if this results in pension savings above £50,000.

However, the new tax limits are towards the less onerous end of the ranges previously suggested, and fewer people will be impacted than many feared.

The Government estimates that only 100,000 people will be affected. However, as there is no current intention to increase the allowances, many more people could be caught in future years,

particularly if inflation increases significantly.

Those in defined benefit schemes may be further impacted by a change in the factor to be used to calculate the taxable value of their pension accrual. This factor will be increased from 10 to 16.

Without prompt action, some employees will find that they face an unexpected and unwelcome tax bill for 2011/12. The new limits apply in less than six months and this tight timescale will place great demands on employers over the first quarter of next year and beyond.

## Headline announcements

### *Annual and lifetime allowances*

The annual allowance (maximum amount of tax exempt pension savings that can be built up in one tax year) will be reduced from £255,000 to £50,000 a year from April 2011.

The lifetime allowance (overall maximum capital amount of tax exempt pension savings that an individual can build up in all their pension arrangements over their lifetime) will be reduced from £1.8m to £1.5m from April 2012.

## ***Future increases***

The above new allowances will be frozen for the time-being. However, the Government will consider options for indexing them from 2015/16.

## ***Tax charges***

The annual allowance tax charge will be at an individual's marginal tax rate.

The lifetime allowance tax charge will remain unchanged at 55% if benefits are paid as a lump sum and 25% if paid as an annual pension (on top of the marginal rate of tax on the pension income). The factor for valuing the lifetime allowance remains at 20.

## ***Treatment of defined benefit accrual***

The value of the increase in a defined benefit pension over the year will be deemed to be 16 times the increase in the accrued pension, after allowing for indexing the pension at the start of the year in line with CPI (measured from September to September).

## ***Exceeding the allowance***

If an individual exceeds the annual allowance in the year, for example because of an exceptional increase in pension accrual due to a salary rise or augmented benefits on redundancy, any unused allowance from up to three previous tax years can be used to offset against any excess pension savings. Carry-forward will be available against an assumed annual allowance of £50,000 for the tax years 2008/09, 2009/10 and 2010/11.

Protection will be put in place for those individuals who have already exceeded the new lifetime allowance. These transitional protections will apply immediately.

The Government will consult next month on alternatives to give individuals and schemes more flexibility around the payment of tax. They intend to allow tax to be paid by the pension scheme with the individual then receiving a lower pension as a result.

## ***Use of trusts***

The Government has said that legislation will be introduced to ensure employee benefit trusts (EBTs) and funded employer-financed retirement benefit schemes (EFRBS) are "less attractive than other forms of remuneration".

The Government will continue to monitor all other forms of EFRBS and may take additional action.

## ***Former employees***

Pension benefits for former employees (so-called deferred pensioners) will continue to be exempt from the new annual allowance regime.

## ***What next?***

### ***Important questions to consider***

UK employers urgently need to make and implement decisions about pension arrangements for their employees. Specifically, employers need to consider the following questions:

- Should these pension tax changes be used as an opportunity to review the long-term future of retirement provision as part of the employment deal? Or will short-term solutions suffice?
- Do you wish to maintain any current defined benefit pension arrangements or encourage employees to move to more flexible defined contribution arrangements?
- What alternatives are available for long-term retirement savings in addition to, or instead of, pensions?
- What should be communicated to employees about the impact of these changes and when should this communication take place?

- What employee consultation is required?

Please see Appendix 1 for a list of some of the considerations which will need to be addressed.

## Next steps for employers

Many employers are already implementing next steps, which may include:

- Identifying which employees may be caught by the new lower annual and lifetime allowances.
- Deciding what initial communications to send to employees on the impact of the changes.
- Determining whether to support, adjust or close existing (defined benefit) pension arrangements.
- Establishing whether to allow employees to restrict pension benefits to be within the allowances and whether to provide top up remuneration instead.

- Planning implementation strategy before 6 April 2011, allowing time for changes to existing arrangements, launch of new arrangements and changes in policies, processes and systems.

## *Further information*

Please see Appendix 2 for illustrative examples of how employees may be impacted by these new rules.

For further information, please see:

### **Government announcement made on 14 October 2010:**

[http://www.hm-treasury.gov.uk/d/restricting\\_pensions\\_summary141010.pdf](http://www.hm-treasury.gov.uk/d/restricting_pensions_summary141010.pdf)

### **Ministerial statement issued by HM Treasury:**

[http://www.hm-treasury.gov.uk/d/wms\\_pensionstaxrelief\\_141010.pdf](http://www.hm-treasury.gov.uk/d/wms_pensionstaxrelief_141010.pdf)

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***Appendix 1: There are many considerations, including:***

- Approval processes (including remuneration committee)
- DB or not DB
- Early retirement
- Employee communication
- Employee consultation
- Employee representatives
- Final salary or career average
- Global retirement policies
- Ill-health
- Individual employee option election
- Individual employee statements
- Individual v collective approach
- International assignees (inbound/outbound)
- Investment options
- Level of cash alternative
- Level of employer payments into alternative vehicles
- Life assurance
- Link with changes in other elements of pay and wider reward
- Other forms of defined benefit reduction
- Pension input period
- Policy for paying tax (scheme pays)
- Processes, systems, administration
- Redundancies
- Salary caps
- Stakeholder decision making
- Treatment of national insurance charges
- Trust deed and rules alterations
- Trustee engagement
- Use of carry-forward
- UURBS

## Appendix 2: Illustrative impact of new annual allowance

In these examples salary refers to the salary for pension calculation purposes.

The following chart shows the salary at which the pensions tax will start to apply for an employee who participates in a 1/60th final salary pension scheme.

The higher the number of years past service and the higher the salary increase, the lower the level of pensionable salary at which someone becomes affected.

Salary at which annual allowance applies			
Standard final salary pension scheme (one-sixtieths accrual)			
Salary increase in year above CPI	Number of years of past service		
	10	20	30
0%	£183,824	£183,824	£183,824
2%	£151,210	£130,208	£114,329
4%	£128,425	£100,806	£82,965
8%	£98,684	£69,444	£53,571

### Amount of tax payable

The following charts show the amount of tax payable in the year by an employee who participates in a 1/60th final salary pension scheme.

The amount of tax is driven by three factors: the level of the employee's salary; the amount of any pay increase in the year; and the number of years of past service.

Amount of tax payable for employee earning £100,000 pa at start of year			
Standard final salary pension scheme (one-sixtieths accrual)			
Salary increase in year above CPI	Number of years of past service		
	10	20	30
0%	£0	£0	£0
2%	£0	£0	£0
4%	£0	£0	£5,133
8%	£333	£11,000	£21,667

Amount of tax payable for employee earning £150,000 pa at start of year			
Standard final salary pension scheme (one-sixtieths accrual)			
Salary increase in year above CPI	Number of years of past service		
	10	20	30
0%	£0	£0	£0
2%	£0	£3,800	£7,800
4%	£4,200	£12,200	£20,200
8%	£13,000	£29,000	£45,000

Amount of tax payable for employee earning £200,000 pa at start of year			
Standard final salary pension scheme (one-sixtieths accrual)			
Salary increase in year above CPI	Number of years of past service		
	10	20	30
0%	£2,200	£2,200	£2,200
2%	£8,067	£13,400	£18,733
4%	£13,933	£24,600	£35,267
8%	£25,667	£47,000	£68,333

Amount of tax payable for employee earning £250,000 pa at start of year			
Standard final salary pension scheme (one-sixtieths accrual)			
Salary increase in year above CPI	Number of years of past service		
	10	20	30
0%	£9,000	£9,000	£9,000
2%	£16,333	£23,000	£29,667
4%	£23,667	£37,000	£50,333
8%	£38,333	£65,000	£91,667

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