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Pension Schemes, Contributions and Tax Relief

6 April 2006 (known as 'A' Day) saw the introduction of unifying rules for all occupational and personal pension schemes that are registered as qualifying for tax relief.

Non-registered pension schemes continue, but without any tax advantages.

Contributions

Under the new rules there is no limit to the number of schemes an individual may belong to. Most of the contribution restrictions have been replaced by two overall key controls:

Annual allowance (AA)

Annual contributions up to the level of earnings (or £3,600 gross if greater) attract tax relief. Contributions above these levels will not receive any relief and there will be a tax charge to the extent that the increase in pensions savings in a tax year exceeds the AA.

Lifetime Allowance (LTA)

This is taken into account whenever benefits are withdrawn. At the first withdrawal, any funds used in excess of the LTA will be taxed at 25% to the extent that they are used to buy a pension or 55% in the case of lump sum payments.

Scheme Investment

One of the features of the new system was the lifting of restrictions on types of investment, and it is possible for registered pension schemes to invest in more or less anything.

However, the Government removed the tax advantages where *self-directed pension schemes* invest in residential property or certain other assets such as fine wines, classic cars and art & antiques. This is to prevent people benefiting from tax relief in relation to contributions made for the purpose of funding purchases of holiday or second homes and other *prohibited assets* for their or their family's personal use.

Borrowing by schemes to increase investments is limited to 50% of the fund.

Tax Free Lump Sums

All schemes now have the ability to offer members a tax free lump sum of up to 25% of their pension fund (limited by the LTA).

Benefits

The minimum age for drawing benefits is 55, although people in schemes with early retirement dates will maintain their rights to draw benefits early. It is not necessary to retire before benefits can be drawn.

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Employers

Employers are able to claim tax relief for contributions paid to a registered pension scheme. Exceptionally large contributions will be spread over 2 to 4 years.

Administration

The complex approval process for pension schemes has been replaced by a simplified regime requiring registration only. Schemes that were approved schemes before A-Day have automatically become registered schemes.

Transitional arrangements protect pre A-Day pension rights (including rights to lump sum payments).

Pension Contributions and Tax Relief

Scheme Members

Any member of a registered pension scheme may make unlimited contributions to a registered pension scheme. However to qualify for tax relief a contribution must be a *relievable pension contribution* made by a *relevant UK individua*l.

Most member contributions are relievable, unless they fall into any of the following categories:

- contributions after age 75
- contributions paid by employers (see below)
- age related rebates or minimum contributions by HM Revenue & Customs (HMRC) to a contracted-out pension scheme

A relevant UK individual is an individual who

- has relevant UK earnings chargeable to income tax for that tax year
- is resident in the UK at some time during the tax year
- was resident in the UK at some time during the immediately preceding five tax years and also when joining the pension scheme

The maximum amount of contributions on which a member can claim relief is the greater of:

- the *basic amount* (currently £3,600)
- the amount of the individual's relevant UK earnings for the tax year

This means that a member who has no relevant UK earnings may still qualify for tax relief on contributions into a registered pension scheme up to the basic amount. The relief in these circumstances can be given only if the contribution is made to a scheme that operates the relief at source (RAS) system. The relief is available even if the individual is a non-taxpayer.

A registered pension scheme must operate RAS unless the scheme rules specifically provide that it can operate net pay arrangements or accept contributions gross from members. Under RAS, premiums are paid

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net of basic rate tax which is claimed back by the scheme administrator. Higher or additional rate relief can be claimed through the member's Self Assessment tax return.

With net pay arrangements, the employer deducts the relievable pension contribution from employment taxable income before operating PAYE (so tax relief is obtained by paying the contribution out of pre-tax income). A member making payments in full (that is, out of after-tax income) has to claim the tax relief from HMRC, generally through the Self Assessment system or PAYE code.

If the total contributions result in the *Annual allowance* being exceeded, there might be a tax charge on the member (see below).

Employers

Any employer of a member of a registered pension scheme may make contributions to that registered pension scheme. Unlike for scheme members, there is no set limit on the amount of tax relief that an employer may receive in respect of its contributions.

Other persons

A person other than a member or employer may make a contribution to a registered pension scheme in respect of a member of that scheme. A person can be an individual, a corporate body or other legal entity. Where the contribution is paid under RAS, it is only the member who may claim higher rate relief on the contribution. Where a third party pays a RAS contribution, such contributions are treated as if made by the individual who is the member of the scheme, not the person who made the contribution. The contribution is paid net, and the basic rate tax is claimed by the scheme on behalf of the member, who can claim higher or additional rate relief in the normal way.

Refund of Contributions

There are two circumstances where contributions to a registered pension scheme may be refunded back to a member:

- *short service refund lump sum*, where an employee leaves pensionable service within two years of joining an occupational pension scheme (taxable on the scheme administrator)
- *refund of excess contributions lump sum*, to cover the amount of contributions that cannot receive tax relief (tax free)

Annual allowance

The *annual allowance* (AA) is £50,000 with effect from 6 April 2011. AA is the amount by which the total *pension savings* can grow each year; above this value the surplus gives rise to an *annual allowance charge* as the individual's top slice of income.

Pension savings

Members of defined contribution (DC) schemes, in particular personal pensions (PPs), will need to look at the total of the contributions (whether personal, employer or third party) during the pension input period

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(PIP) for all of their pension savings. The PIP is usually the scheme year to the anniversary date which falls within the relevant tax year. Members of defined benefits (DB) schemes, such as occupational final salary schemes, will have to work out how much their accrued pension has increased during the PIP (see below for a worked example). Pension scheme administrators will be responsible for providing information to their members on their pensions savings for each tax year if those savings exceed the AA, or at the request of a member.

Example: Self employed personal pension with AA charge

Alison, who is self employed, has taxable income of £110,000 in 2011-12. She is a member of two different PP schemes. Scheme A has a PIP ending on 31 March; Scheme B's ends on 30 November. She contributes £2,000 per month (£2,500 before basic rate tax relief) to Scheme A and £2,800 per month (£3,500 before tax relief) to Scheme B. She has been contributing similar amounts to these schemes for the previous three tax years. During the tax year ending 5 April 2012, her total pension contributions are:

Scheme A (year to 31 March 2012)	£30,000
Scheme B (year to 30 November 2011)	£42,000
Total pension savings	£72,000
AA for 2011/12	£(50,000)
Excess subject to AA charge	£22,000

The AA charge will therefore be £8,800 (£22,000 @ 40%). Alison will have had full tax relief of £28,800 (£72,000 @ 40%) on her pension contributions during the year, so the overall relief is effectively reduced by the AA charge.

The three year carry forward rule

Unused AA for the previous three tax years can be carried forward and added to the current year's £50,000 AA. For the tax year 2011-12, the first of the new regime, carry-forward will be available against an assumed AA of £50,000 for each of the tax years 2008-09, 2009-10 and 2010-11. The total usable amount is called the 'available AA'.

No carry forward is available from an earlier tax year unless the individual was a member of a registered pension scheme at some time during that tax year.

Example: Self employed with available AA

Michael is self employed. Each year he pays part of his profits into his PP. His contributions have been:

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2010-11 - £31,000
2009-10 - £39,000
2008-09 - £26,000

In 2011/12 Michael has a good trading year and decides to contribute £92,000 to his PP. He has £54,000 unused AA that he can carry forward to 2011-12. This is broken down and used as follows:

	Available	**Used 2011-12**
2010-11	£19,000	£7,000
2009-10	£11,000	£11,000
2008-09	£24,000	£24,000
	£54,000	**£42,000**

Michael does not have to pay the AA charge on his pension savings of £92,000. He also still has unused AA of £12,000 that he can carry forward.

Defined benefit schemes

In defined benefit (DB) schemes, individuals accrue a right to an amount of annual pension from pension age. To treat DC and DB schemes in a comparable way, it is necessary to deem the value of notional contributions in a DB scheme. These notional contributions should reflect what would need to be invested in a DC scheme to deliver the extra annual pension accrued in a DB scheme.

However, the calculation needs to be as simple as possible so a ‘flat factor’ method will be used. The Government has decided that the level of the factor will be set at 16 meaning, broadly, that an increase in annual pension benefit of £1,000 would be deemed to be worth £16,000.

Example: DB scheme

Nicole has been a member of her employer’s DB scheme for 30 years. The scheme provides a pension of 1/60th pensionable pay for each year of service. In her 31st year, she receives a pay rise from £35,000 to £45,000.

Opening annual pension entitlement	30/60 x £35,000 =	£17,500
Closing annual pension entitlement	31/60 x £45,000 =	£23,250
Increase in annual pension entitlement		£5,750
Deemed contribution	16 x £5,750 =	£92,000

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So Nicole may have to pay an AA charge on the £42,000 surplus over the £50,000 limit, depending on whether carry forward relief is available. The contribution is relatively large in this example due to the combination of long service and a large pay rise.

If Nicole had left the scheme after 30 years, then the pension at the end of year 31 would have been uprated by the CPI. If the CPI increase is assumed to be 2.5%, then her pension earned after 31 years would have risen from £17,500 to £17,937, a deemed contribution of only £6,992 (16 x £437).

The rate of charge

The AA charge is due on any pension savings over and above the AA available for the year. The effect of the AA charge is to remove tax relief on any pension savings over the available AA and perhaps also to add a liability on employer contributions.

The amount you pay depends on the rate at which tax relief has effectively been given on the excess pension savings, which in turn depends on how much taxable income you have and the amount of your excess pension savings.

To find out the amount of your AA charge you add the amount of your excess pension savings to the amount of relevant income you actually pay tax on. The amount of pension saving:

- over your higher rate limit will be taxed at 50%
- over your basic rate limit but below your higher rate limit will be taxed at 40%
- below your basic rate limit will be taxed at 20%.

Example: Calculation of AA charge

John has £10,000 excess pension saving on which he has to pay the annual allowance charge. John also has £142,000 income that he has to pay tax on. The total of John's taxable income and excess pension saving is £152,000.

For the purpose of this example the higher rate limit is £150,000. The basic rate limit is £40,000. £2,000 of John's excess pension saving is above the £150,000 higher rate limit. £8,000 of his pension saving is above the basic rate limit but below the higher rate limit.

John's tax charge is calculated as:

£2,000 @ 50% = £1,000

£8,000 @ 40% = £3,200

AA charge = £4,200

Transitional rules

It is possible that some individuals will have pension savings relating to a PIP that has already started but which will end in the 2011/12 tax year and so will be subject to the new AA limit. To help individuals in this situation, there will be transitional rules which have effect from 14 October 2010.

You might be affected by the transitional rules if the 2011/12 PIP for any of your pension arrangements begins on or before 14 October 2010. You will not be affected by the transitional rules if the total pension savings for PIPs that end in 2011/12 is below £50,000.

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Where a PIP started before 14 October 2010 but will finish after 5 April 2011, the maximum pension savings you can have in the PIP without paying an AA charge will be £255,000. This will be subject to a maximum of £50,000 pension savings in the period from 14 October 2010 to the last day of the PIP.

Removal of AA exemptions

There is no longer a blanket exemption from the AA in the year benefits are taken. There will, however, be an exemption in the case of serious ill health as well as death.

From 6 April 2011 the exemption from the AA for those with enhanced protection will no longer apply.

Lifetime limit

The lifetime limit, which sets the maximum figure for tax-relieved savings in the fund, currently stands at £1.8m. However, this limit is to be reduced to £1.5m, probably from April 2012.

The lifetime limit has to be considered when key events happen, such as when a pension is taken for the first time. If the value of the scheme exceeds the limit a tax charge of 55% of the excess is due.

The new rules will require careful consideration by many pension scheme members. To discuss how the changes may affect you, please contact us.

We can help with all your financial planning needs and will be delighted to assist you.