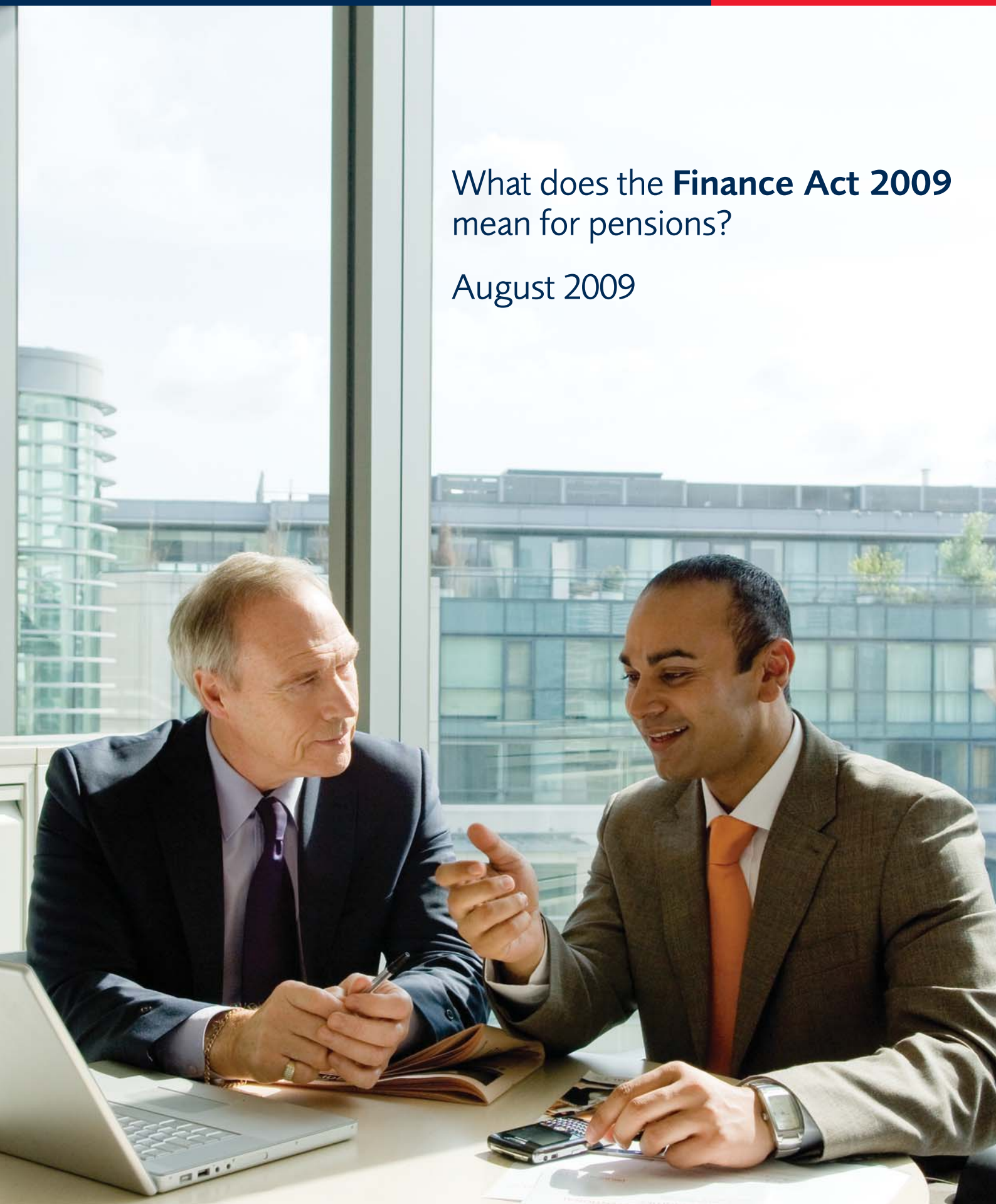


# What does the **Finance Act 2009** mean for pensions?

August 2009



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The following information is based on our understanding, as at July 2009, of current taxation, legislation and HM Revenue & Customs practice, all of which are liable to change without notice. The impact of taxation (and any tax reliefs) depends on individual circumstances.

The extent that these changes will impact an individual will be dependent upon his/her personal tax position.

## Background

This document outlines important information which will help financial advisers understand the key measures introduced in the Chancellor's April 2009 Budget and the following Finance Act 2009.



## Key Changes and possible strategies

### Tax Relief on Pension Contributions

#### In summary

The Chancellor wanted to restrict higher rate tax relief for people with income above £150,000 (this is a wider definition than just 'pensionable earnings').

From April 2011 individuals with income above £180,000 will only receive tax relief at the basic rate of 20% (tapered down from £150,000 to £180,000).

To prevent individuals from making excessive contributions in the intervening period, HM Revenue & Customs have introduced 'anti-forestalling' provisions to tax any contributions above the person's normal level of contributions.

For 2009/10 tax years anyone with annual income above £150,000 can continue to receive full tax relief on contributions above £20,000 as long as this doesn't significantly change in amount or frequency from what they were contributing (or what was being contributed on their behalf) prior to the April 2009 Budget.

#### So, what are the changes being made to tax relief from 6 April 2011?

The Government intends, with effect from 6 April 2011, to restrict tax relief on pension contributions for individuals with an annual income of £150,000 or more. Under the new rules, total income will be used to calculate the rate of tax relief on contributions – not simply 'earnings'.

Tax relief will be "tapered" for those whose annual income is £150,000 or more so that for those earning over £180,000 relief will be at a rate of 20%. The actual rate of decline of tax relief has, however, not yet been decided.

#### What are the 'anti-forestalling provisions'?

The anti-forestalling provisions were announced in the 2009 Budget and take effect from 22 April 2009.

The provisions will affect people:

- Whose 'relevant income' is £150,000 or higher in the current or previous two tax years, and
- who change their normal ongoing regular pension savings, and
- whose total pension savings exceed £20,000 pa.

These provisions were introduced as a means of preventing taxpayers from making artificially large pension contributions prior to 6 April 2011 in order to benefit from relief at 40% (or 50% from April 2010), before the rate of relief for higher earners is restricted from 6 April 2011. These provisions will therefore only apply in the 2009-10 and 2010-11 tax years.

The amount of relief available will be tapered for individuals with income between £150,000 and £180,000, from 50% (the new higher rate tax rate for individuals earning over £150,000) down to 20%, with only basic rate relief available where income exceeds £180,000. The rate at which this relief will be tapered down has not yet been explained by HMRC.

#### What does 'Relevant income' mean?

Relevant income includes total income from all sources, not just earnings. This income would be calculated after normal deductions and reliefs, eg trading losses, pension contributions up to a maximum of £20,000, and gift aid. Other examples could include investment income, rental income and pension income.

As mentioned earlier, the rules take into account relevant income for the current and two previous tax years. For example, if a person's relevant income was less than £150,000 in 2009-10, they would still be subject to the restricted tax relief for that year if their relevant income was £150,000 or more in 2007-08 and/or 2008-09.

Any income sacrificed for pension contributions, as part of a salary sacrifice arrangement entered into after 22 April 2009 will also have to be added back in order to arrive at relevant income when looking at the £150,000 threshold.

#### What contributions will be affected?

Where regular pension contributions continue unchanged the anti-forestalling provisions do not take effect.

Similarly, where contributions made (including all employer and employee) do not exceed £20,000, there will be no restriction of relief.

Where contributions do exceed £20,000 there will be a 20% special allowance tax charge in 2009/10 to reclaim the relief received at 40%. This is the difference between the top rate of tax and basic rate (20% for 2009/10) and will be collected through a Self-Assessment tax return.

#### **The Bill was amended before it came into Law, what was this change ?**

The Act now includes an amendment which affects contributions paid less frequently than quarterly, for example contributions paid singly, annually, half yearly and termly. These contributions are referred to as 'irregular'.

Also, the amendment has introduced a new term 'relevant mean' which is defined as the average of contributions made in the three tax years from 2006/07 to 2008/09.

Where the relevant mean exceeds the £20,000 limit for irregular contributions only, the restriction free limit has been extended to £30,000, or the amount of the relevant mean, if lower.

This means that those making infrequent contributions will be able to benefit from full relief to the lower of £30,000 and the relevant mean. In the initial Act this was restricted to £20,000 for those making more frequent regular contributions.

**As you can see the new rules are quite complicated. The following examples taken from the HMRC website may help you understand these new rules:**

A has income of £55,000 in 2007/08, £58,000 in 2008/09, £59,000 in 2009/10 and £60,000 in 2010/11.

*Since his income is less than £150,000 in all years, he is not affected by the new special annual allowance charge.*

B has income of £158,000 in 2009/10 and has total individual and employer pension contributions to a money purchase scheme of £15,000 in the year.

*Although her income exceeds the £150,000 threshold, her total contributions are less than the £20,000 special annual allowance so she is not subject to the special annual allowance tax charge.*

C has income of £158,000 in 2010/11 and makes contributions to her personal pension scheme of £24,000 during the year of £2,000 per month, something she has done for the previous 2 years. Her income exceeds the £150,000 income threshold.

*Although her pension contributions are more than the £20,000 special annual allowance, they will not be subject to the special annual allowance tax charge because they only reflect her normal regular contributions.*

E has total income of £120,000 in 2009/10 and contributes a total of £30,000 to a personal pension scheme that year. Although his income is less than £150,000 for 2009/10, because his contributions are greater than £20,000 he needs to check his income for the previous 2 tax years. His income was £110,000 in 2007/08 and £125,000 in 2008/09.

*E will not be affected as his relevant income is less than £150,000 even though his contributions are greater than £20,000. In 2010/11 E's total income has risen to £170,000 and he contributes a total of £15,000 to his personal pension scheme in that year. E will not be affected as although his relevant income for 2010/11 is greater than £150,000, his contributions for that year are less than £20,000.*

(Source : Pensions: Limiting Tax Relief for High Income Individuals, April 2009)

**Key points to remember**

1. Only individuals with an income in excess of £150,000 in the current or the 2008/9 and 2007/8 tax years are affected.
2. The definition of income is now wider than just earnings
3. Individuals who pay regular contributions can increase contributions up to £20,000 without incurring a special tax charge of 20%
4. Where the relevant mean exceeds the £20,000 limit for irregular contributions only, the restriction free limit has been extended to £30,000, or the amount of the average of contributions made in the three tax years from 2006/07 to 2008/09 (the 'average mean') if lower.

**What's the impact?**

The changes are not product specific. They are aimed at those with high income, either employed or self employed and their ability to receive full tax relief on pension contributions.

We will look at each of the key changes and consider some possible strategies.

**Possible strategies**

Three approaches seem possible:

- Make contributions in 2009-10 and 2010-11 within the "additional contribution" limit. This creates opportunities for increasing contributions through AVC/personal pension for the next two years subject to the anti-forestalling rules
- Individuals earning under £150,000, but might have reached £150,000 by 2011, should be maximising their pension funding over the next two years and create a 'normal savings pattern'
- Consider non-pension investments to fund retirement.

The tax relief restriction from 2011/12 means higher earners will need to increase the amount they pay to achieve the same level of grossed-up contributions to their fund.

Currently, for example, for every £1,000 of gross contribution, it would cost a 40% taxpayer £600. With only basic rate tax relief, this will rise to £800. Taken in conjunction with the new 50% tax rate, the pre-tax earnings needed to fund this will be considerably more.

This is illustrated in the following table for a gross pension contribution of £1,000:

	Net payment required	Equivalent in pre-tax earnings	
		40% taxpayer	50% taxpayer
Currently	£600 @ 40%	£1,000	n/a
From 2011/2012	£800 @ 20%	n/a	£1,600

### Removal of Personal Allowances

The value of the personal allowance will be restricted for individuals with net adjusted incomes over £100,000. The personal allowance will taper down to zero.

This will come into effect in 2010-11 (i.e. with effect from 6 April 2010).

The personal allowance will be reduced by £1 for every £2 that income exceeds £100,000 until it is reduced to nil. This means that the marginal rate of tax on earnings where the allowance is lost is 60%:

- For every £2 earned above limit, £1 allowance is lost
- So, effectively paying tax on £3 at 40% = £1.20
- £1.20 tax on £2 income = 60% marginal tax rate

The following is an example of how personal allowances will be reduced:

#### Case study 1

Alex has income for 2010-11 of £108,000. None of this comes from dividends.

Her personal allowance for that year will be reduced by  $(£108,000 - £100,000) / 2 = £4,000$

Assuming that the personal allowance for 2010-11 is £6,475 her available allowance will be reduced to £2,475 and her tax liability for that year, assuming continuance of current rate bands, will be £34,730 (see below):

Income	£108,000
Personal Allowance	<u>£ 2,475</u>
Taxable	£105,525
Tax £37,400 @ 20%	£ 7,480
£68,125 @ 40%	<u>£ 27,250</u>
Total tax liability	£ 34,730

The effect of planning is most apparent where an individual's income falls between £100,000 and £112,950 (assuming personal allowance remains at £6,475).

The following shows the impact on Alex's tax liability (from case study 1) if she makes a pension contribution of £5,000 gross (£4,000 net of basic rate tax relief).

Income	£108,000
Pension contribution	<u>£ 5,000</u>
Taxable Income	£103,000

Reduction in personal allowance  $(£103,000 - £100,000) / 2 = £1,500$

$£6,475 - £1,500 = £4,975$

Taxable Income	£103,000
Personal Allowance	<u>£ 4,975</u>
Taxable	£ 98,025
Tax £37,400 @ 20%	£ 7,480
£60,625 @ 40%	<u>£ 24,250</u>
Total tax liability	£ 31,730

Alex has achieved a reduction in her tax liability of £3,000 - equivalent to 60% of the pension contribution.

Salary sacrifice or bonus sacrifice may also be a way of preserving personal allowances, reducing tax and sharing national insurance savings with employers.

### What is a salary sacrifice?

A salary sacrifice happens when an employee gives up the right to receive part of the cash pay due under his or her contract of employment. Usually the sacrifice is made in return for the employer's agreement to provide the employee with some form of non-cash benefit. The 'sacrifice' is achieved by varying the employee's terms and conditions of employment relating to pay.

Salary sacrifice is a matter of employment law, not tax law. Where an employee agrees to a salary sacrifice in return for a non-cash benefit, they give up their contractual right to future cash remuneration.

Employers and employees who are thinking of entering into such arrangements would be well advised to obtain legal advice on whether their proposed arrangements achieve their desired result.

### When is salary sacrifice effective?

Salary sacrifice arrangements are effective when the contractual right to cash pay has been reduced.

For that to happen two conditions have to be met:

- (1) the potential future remuneration must be given up before it is treated as received for tax or NICs purposes, and
- (2) the true construction of the revised contractual arrangement between employer and employee must be that the employee is entitled to lower cash remuneration and a benefit.

### When is salary sacrifice not effective?

A salary sacrifice is not effective if, in practice, the arrangement enables the employee to continue to be entitled to the higher level of cash remuneration. In other words the employee has merely asked the employer to apply part of that cash remuneration on his behalf.

### Budget 2009 Implications?

Where a salary sacrifice agreement is made on and after 22 April 2009, the amount sacrificed will still count towards the member's income for the purposes of the Anti-Forestalling requirements (i.e. tax relief on pension contributions for people earning over £150,000).

### Introduction of a 50% Income Tax

The rate of income tax on income over £150,000 will be 50%. The highest rate of tax on dividend income will be 42.5%.

This will come into effect in 2010-11 (i.e. with effect from 6 April 2010).

Here's an example of how the increase in income tax would be applied:

#### Case study 2

Brian has an income for 2010-11 of £170,000. None of this comes from dividends. He will have no entitlement to personal allowance. His tax liability will therefore be:

Income	£170,000
Tax £ 37,400 @20%	£ 7,480
£112,600 @40%	£ 45,040
£ 20,000 @50%	<u>£ 10,000</u>
Total tax liability	£ 62,520

The proposals effectively mean that the rate of tax moves up to 60% as a result of the changes to the personal allowance before moving down to 40% and then finally up to 50%. Thus:

Taxable income £100,000 - £112,950 - effective marginal rate of tax 60%

Taxable income £112,951 - £149,999 - effective marginal rate of tax 40%

Taxable income of £150,000 + - effective marginal rate of tax 50%

A key strategy might be to use pension contributions to reduce taxable income.



## Conclusions

Despite an added level of complexity caused by this change, we believe that people need to take steps now to plan ahead for a comfortable retirement – which is reinforced by research published by the ABI that a relatively few individuals are likely to be affected by the changes following the Finance Act 2009.

The ABI's Savings and Protection survey for the first quarter of 2009 shows that the lack of retirement provision continues to be a serious problem. Approaching half (42%) of the UK workforce face financial problems in retirement. Some 13% of people are currently saving at levels unlikely to provide an adequate income, whilst an alarming 30% are saving nothing for their retirement\*.

The changes introduced in the Chancellor's Budget in April, such as the introduction of 'anti-forestalling rules' and tapering down of income tax relief on pension contributions and personal allowances will have little effect on the majority of employees.

(\* ABI Savings and Protection Survey, 2009)

## Notes

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