

# Hot topics

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## Restriction of tax relief on pension contributions for high earners

The new Government has listened to the vociferous and widespread criticism of the method by which its predecessor proposed to restrict pensions tax reliefs from 2011.

Due to the current parlous economic conditions, it is committed to restrictions, but it has expressed “reservations about the approach adopted” and indicated support for controlling relief through an existing mechanism - the annual allowance - modified and reduced drastically. This would be conditional on the approach raising “at least the same amount of revenue” (around £3.5 billion a year) as the regime that it would replace.

The Government’s initial analysis suggests that an appropriate level for such an annual allowance would lie within the range of £30,000 - £45,000; an 80 - 90 per cent reduction from its current level of £255,000. In effect, this would be the price to pay for allowing higher earners to continue to participate in tax-privileged pension savings. The Government hopes - and has been told by those advocating such an approach - that this would secure senior employees’ continued engagement with company pension schemes.

The Government recognises that there are many features of the existing annual allowance that would need to be modified for it to operate “fairly and effectively”, including:

- How defined benefit pension accrual should be valued.
- Options to ensure basic-rate taxpayers are not subject to the restriction, and to minimise difficult cases caused by one-off ‘spikes’ in pension accrual.

- Whether and how there could be flexibility for individuals to pay any charges that arise.
- How compliance and delivery would operate in practice.

It has said that it wishes to engage interested parties to determine the best design of a modified regime, taking into account relevant issues.

The scale of the task in resolving these problems should not be under-estimated; all have been considered before and none is straightforward. But of greatest concern must be how such a regime could be delivered by 6 April 2011.

The Finance Act 2010 approach for restricting tax relief on pension contributions for higher earners will come into force on 6 April 2011. The Government has said that it will revoke this legislation, but only “once it has decided on the detail of its approach”. It has also stated that its “over-riding concern will be the delivery of the fiscal objective [that whatever approach is followed delivers the same reduction in tax expenditure]”.

This fiscal commitment, laudable in itself, is likely to have been influenced by the willingness or otherwise of the Office for Budget Responsibility to include the £3.5 billion annual savings, when commenting on whether the Budget measures will meet the Government’s targets.

If an appropriate alternative regime cannot be agreed and implemented by 6 April 2011, we may yet end up with the existing proposals. This would be far from ideal and, if it is instead necessary to transition to a 'fully-polished' final annual allowance regime, it might be preferable to operate an unsophisticated (and possibly less fair) annual allowance regime in the meantime.

## Controlling tax reliefs through a reduced annual allowance test

A reduced annual allowance (RAA) would impact predominantly on higher earners, but has the potential to reach much further down the income scale than the currently-legislated 2011 regime – the high income excess relief charge (HIERC) regime. That regime is set to withdraw tax relief on pension contributions gradually for individuals who have an income of at least £150,000 (hitting a floor of 20% tax relief, once income is one pound over £179,000).

An RAA approach would also have a slightly different effect to that which it replaces. Both approaches would successfully reduce the tax spend on pension savings, but the previous Government (and indeed the Liberal Democrat election manifesto!) wanted to re-focus pensions tax relief away from highest earners, restricting tax relief on all pension savings for that group. Under the RAA approach, 50% tax-payers will continue to receive 50% relief on their pension savings (within the RAA) and, on the assumption that few are likely to remain 50% tax-payers into retirement, will receive a genuine tax advantage, rather than tax deferral.

## Why is RAA favoured over HIERC?

The attraction of the RAA lies in its ability to retain senior employees' engagement with the company pension scheme and also in the relative simplicity of the existing annual allowance approach, in comparison with that of the HIERC regime.

There are three main elements to this simplicity.

1. Under the HIERC regime, to determine whether an individual would be subject to the new restrictions, it would be necessary to determine whether total UK income (not just earnings) reached £130,000. If this threshold were reached, it would then be necessary to determine the individual's adjusted income, inclusive of the value of any personal and employer pension savings made on his or her behalf. Only if adjusted income reached

£150,000 would the new restrictions have applied. This complexity is not present under the annual allowance.

2. The existing annual allowance valuation process for DB rights is far simpler than that under HIERC.
3. The annual allowance tax charge is a flat rate - 40%. This is also much simpler than the HIERC approach, which, for members with an adjusted income between £150,000 and £180,000 would have faced a tax charge of between 1% and 30%, depending on precise income. Although the maximum tax rate under HIERC would have been less than the rate under RAA, the RAA tax rate applies only to value in excess of the annual allowance.

A further advantage of the RAA approach is that it would appear more resilient than HIERC to changes in the top rate of income tax.

## Modifying the existing annual allowance test to fit its new purpose

Remembering that the annual allowance was intended as a secondary control within the A-day regime, consideration will need to be given also to other features of the existing annual allowance test that would need modification, to enable it to operate as a primary control on tax relief.

### Appropriate valuation factor for defined benefit accrual

The current approach values the increase in defined benefit (DB) accrual, by multiplying it by a flat factor of ten. This is unquestionably simple. Simple, yet inherently unfair. This unfairness was of little significance to an unreduced annual allowance, as it affected so few individuals. At a much lower level, such sentiment is unlikely to persist.

A flat factor makes no allowance for the fact that, at younger ages, funds can remain invested for longer - a smaller initial contribution is needed to provide the same output. The consequence of a single factor is that it overstates the value of accrual at younger ages and understates it at older ages. Even if the factor is penal for all, it will be more punitive for younger members. DB members might balk at facing a tax charge based on such a broad-brush valuation.

There might also be strong opposition to a flat factor approach from individuals accruing DC pension rights, if those individuals believe that members of DB schemes (predominantly public sector

employees) are receiving more favourable tax treatment of their pension rights – after all, few members of DC pension schemes have any option to elect DB provision instead.

### Pension input period

The existing annual allowance test considers pension accrual over a “pension input period”. Although that period does not currently need to align with the tax year, presumably, such a mis-match would not be permitted to continue in a regime in which the annual allowance would be the primary control on tax relief. Addressing this would present its own set of problems and could, for example, lead to a member having two input periods in the tax year 2010-11. This might then lead either to an unexpected tax charge for members, or an opportunity for avoidance.

### Accrual to be valued

The defined benefit to be valued, again under the existing annual allowance test, is determined as the difference between the accrued rights at the start and end of the pension input period. However, those rights are defined as the benefit to which the member would be entitled on the assumption that he or she became entitled to it at the end of the input period and had reached the age from which no actuarial reduction for early payment would apply. Pension schemes do not routinely undertake this calculation (other than when benefits become payable).

### Propriety of existing exemptions from the annual allowance test

There are certain exemptions from the existing annual allowance test that would need to be reconsidered. The most significant of these are:

- The exemption in the tax year in which an individual puts into payment all their benefits from an arrangement (the so-called “final year” exemption), and
- The exemption for individuals who have registered for enhanced protection.

It would seem likely that these would not normally continue. However, to protect those who are lower on the income distribution from being caught, some protections and exemptions might be available (see next section) – in some circumstances, the final year exemption might therefore survive.

The problem, of course, with any exemption is that it tends to be accompanied by a complicated anti-avoidance provision.

## Appropriate targeting of restrictions

The Government has said that it wishes to protect basic-rate taxpayers from the restrictions, and to support difficult cases caused by one-off ‘spikes’ in pension accrual.

Within defined contribution arrangements this is straightforward, as contributions are considered at face value (and can be restricted, where appropriate). It is altogether less straightforward where there is defined benefit provision.

It is not yet clear how the charge will be applied to defined benefit pension accrual. The table below shows the tax charges that would be incurred by members of defined benefit schemes offering 1/60<sup>th</sup> of final salary for each year of service if the Government multiplied the annual pension by 15 and set the annual allowance at £35,000. This assumes that no uplift is applied to the starting value to reflect inflation – another detail that has yet to be confirmed.

In each case it is assumed that the individual receives a 5% pay rise during the year. In a final salary scheme, each pay rise that someone gets increases the value of the pensions they have earned in the past. This means that people earning as little as £60,000 could sometimes be caught if they are in the latter stages of a long career with one employer – though it is generally people further up the income scale who will be affected.

Number of years service at start of year	Salary at start of year and tax charge (£)				
	£60,000	£70,000	£80,000	£90,000	£100,000
10	0	0	0	0	1,500
15	0	0	400	2,200	4,000
20	0	350	2,400	4,450	6,500
25	0	2,100	4,400	6,700	9,000
30	1,300	3,850	6,400	8,950	11,500
35	2,800	5,600	8,400	11,200	14,000

Source: Towers Watson

Scheme design can help to offer protection, by seeking to restrict the value of accrual to the annual allowance. This could include, for example, an appropriate cap on pensionable salary. However, the more complicated the methodology for valuing accrual, the more difficult the task in capping accrual value – certainly if there is to be any reasonable prospect of explaining this to members.

Introducing an exemption that operates by reference to an income would return much of the complexity of the much-criticised HIERC regime that the Government is seeking to replace and should be avoided at all costs.

## Flexibility for individuals to pay any charges that arise

The mechanism for determination and collection of the annual allowance (AA) is, at least currently, the annual self-assessment return. This could present members, particularly any who are lower on the income distribution, with tax bills that they are ill-equipped to pay.

Such an outcome supports the case for a smoothing mechanism and the administratively-intensive scheme pays option – a feature under the HIERC regime – will surely be the prime contender. Under this option, a member can elect that the scheme meets the tax charge, where this exceeds £15,000, reducing his or her benefit entitlement accordingly. This would not be welcomed by pension schemes, but there are few other viable options that have been identified to date.

Using self-assessment as the tax collection mechanism presents a further complication. In theory, all individuals with an income in excess of £100,000 are automatically within the self-assessment system. However, as determined in the table above, the reach of a RAA approach would extend to many individuals on income levels below £100,000. Such individuals would need to:

1. Understand that they have a tax charge to meet, and
2. Request a self-assessment tax return from HMRC, complete the form and file it within the self-assessment deadlines.

One possible solution to this, at least for members with defined contribution rights, could come through the PAYE improvement project, which officials have been studying for a number of years and the Government is now exploring further. Under these reforms, employers would send gross wages to a clearing house, which would deduct income tax before paying the net amount into the employee's bank account. The Government might explore whether a variation on this theme might also apply to pension contributions, remitting an amount net of any tax charge to the pension scheme, where the aggregate contribution exceeds the annual allowance.

## Compliance and delivery

In an ideal world, individuals should be capable of determining the value of their pension input. For members accruing defined benefit rights, if the valuation methodology is anything other than simple, this might not be possible.

The previous Government indicated its willingness to pass responsibility for the valuation of pension rights to pension schemes and it is difficult to envisage a different outcome for any alternative set of proposals.

If schemes are required to determine and notify members of the value of their contributions and/or accrual, the Government might not consider it too onerous a requirement to similarly notify HMRC, where a member's accrual value exceeds a percentage of the RAA.

## Interaction with the lifetime allowance

The Government has said that, as part of the evaluation of a RAA regime, it will include consideration of an appropriate level of the lifetime allowance (currently £1,800,000).

If the primary control for pensions tax reliefs is to be a reduced annual allowance, then the need for the lifetime allowance test falls away. The difficulty with such a proposition is that this would re-open tax-privileged pension savings to individuals who have been effectively precluded from such provision (those who have opted out having reached the level of the lifetime allowance).

## Anti-forestalling

Despite the fact that the proposed new regime would impact lower down the income scale than the currently-legislated 2011 regime, the Government has proposed no changes to the anti-forestalling rules that apply through to 5 April 2011.

Those rules were designed for the HIERC regime, with the consequence that they impact only on individuals with an income level of at least £130,000. Although this presents a potential opportunity for those on lower incomes to forestall the new rules, it would seem that the Government is sanguine that few individuals within the risk group will have the means or desire to do so. This is welcomed.

## How attractive is a reduced annual allowance approach?

There is a tension between simplicity and fairness and, in relation to valuing DB rights, this tension is considerable. The existing annual allowance approach is undeniably simple, but how much movement from the existing regime will be needed to deliver a regime that is both acceptable and durable?

It is not difficult to imagine representations to the Government resulting in a greater emphasis on fairness and less on simplicity (as happened repeatedly, following the Finance Act 2004 "simplification" proposals).

Any adjustments to deliver fairness will inevitably mean more complication. It remains to be seen how far along this line the Government is pushed, but such movement has the potential to return much of the complexity of the 2011 regime that it wishes to replace. And it would return that complexity within a regime that impacts on a far greater number of individuals.

## What next?

The Government has indicated its desire to engage with interested parties on an appropriate design for a RAA regime. There will be no formal consultation; quite simply there is no time for this.

Finance (No 2) Bill will be published shortly, but the existing (currently-legislated) 2011 restrictions are unlikely to be revoked yet. This leaves open the prospect of that regime coming into force - an outcome unlikely to be relished by many.

A two-stage transition (via a crude annual allowance approach) to the new regime would seem preferable and would allow thorough reflection of the issues, hopefully also minimising the need for future modifications.

Where the Government chooses to strike the balance between fairness and simplicity will be critical in ensuring the success of an annual allowance approach. It is not a panacea.

## Further information

For further information, please contact your Towers Watson consultant, or:

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