

Pension possibilities

January 2010

Since the government's assault on pension tax relief in the last budget and the subsequent pre-budget report, we've been carefully reviewing the guidance notes, press releases and Finance Act legislation that support the tax changes. Although we've had to lock ourselves away in a darkened room and put our social lives on hold, the Bloomsbury wealth team now has a clear idea of how clients can make use of the tax planning opportunities and how best to thwart the tax grab.

Just to recap what has happened in the 2009 Finance Act and other changes previously announced :

- The annual and lifetime allowances will be frozen at the 2010/11 rates of £255,000 and £1.8m respectively at least until 2015/16;
- The personal allowance will be removed on relevant income in excess of £100,000 from 6 April 2010;
- Tax relief on registered pension scheme contributions will be restricted for individuals with 'relevant income' of more than £150,000 from 2011/12
- The definition of 'relevant income' will, from 2011/12, include the value of employer pension contributions (except those with incomes of less than £130,000 before the inclusion of employer pension contributions);
- The imposition of anti-forestalling measures to avoid significant pre-emptive planning by tax payers using pensions before 6 April 2011.

Frozen limits

The lifetime limit will remain at £1.8m for at least five tax years from 6 April 2010 for those who do not benefit from transitional protection. The normal annual allowance for 2009/10 is £245,000 but for 2010/11 and subsequent tax years it will be £255,000. The annual allowance is based on the tax year in which the pension scheme's 'input period' finishes. For many schemes the input period is the same as the tax year but it can be changed if necessary and, subject to having sufficient earnings, would allow a contribution of up to £500,000 in 2009/10 and £510,000 in 2010/11.

For most individuals this is unlikely to have much of an impact, whether because they have nowhere near £1.8m of accrued pension assets and do not envisage being able to get there, because the new tax rules make it unattractive to make significant pension contributions or because it is not possible to fund them because they have either insufficient earnings or insufficient financial resources.

Over time, and with reasonable fund growth, an increasing number of pension investors will be in danger of exceeding the lifetime allowance. Those with transitional protection may have seen their fund value fall since 6 April 2006 (the value on the date on which their protection application was based). In either scenario a careful review of the pension investment strategy, future contribution levels or both would be advisable.

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The 60% tax trap

From 6 April 2010, personal allowances will be reduced by £1 for every £2 of adjusted net income over £100,000. This could result in an effective rate of tax of 60% for individuals earning between £100,000 and £100,000 plus twice the standard personal allowance from the 2010/11 tax year onwards.

For example, someone with an income of £110,000 would not only be liable to 40% tax on the top £10,000 'slice' of their salary but would also lose £5,000 of their personal allowance (£1 for every £2 above £100,000). This amount of £5,000 would be liable to 40% tax, meaning the overall tax liability on the individual's top £10,000 slice of salary is effectively £6,000, or 60%. Pension contributions can help to avoid this problem (see below).

Pension tax relief restrictions

From 6 April 2011 the government intends to restrict tax relief on contributions paid to registered pension schemes for those with income, from all taxable sources, of more than £150,000 per annum. Where income is in excess of £130,000 then then the value of any employer contributions or benefit accrual will be added back to determine whether the £150,000 threshold has been breached. . Although the detailed legislation or rules have yet to be published, Her Majesty's Revenue and Customs (HMRC) has published a 115 page consultation document indicated that this will cause a gradual tapering away of tax relief until only 20% relief is available for those with income over £180,000 per annum. Clearly it will be difficult to devise planning solutions for post April 2011 until the details are finalised following the current consultation. Between now and then a lot can happen, including a general election!

The fundamental change being made is to restrict the immediate tax benefits of pensions for very high earners so that they become equivalent to those for basic rate taxpayers (though that equivalence disappears for those who still pay higher rate tax after retirement).

Table 1 demonstrates the wide range of possible situations after 2011. It allows for the tax relief received on contributions, the tax-free pension commencement lump sum and the taxable pension. We've shown the most likely scenarios in bold.

Table 1

Gain (loss) from investment in pension – excluding investment returns				
	Tax rate on benefits			
Top tax rate on contribution	0%	20%	40%	50%
0% or 20%	+25%	+6%	-12%	-22%
30%	+50%	+19%	0%	-13%
40%	+67%	+42%	+17%	+4%
50%	+25%	+6%	-12%	-22%

In the meantime HMRC has introduced anti-forestalling rules which have the effect, on the face of it, of restricting higher rate tax relief on pension contributions (or the cash value of defined pension benefits accrued) in excess of £20,000 (or up to £30,000 in some circumstances) per tax year and paid between 22 April 2009 and 5 April 2011.

The restriction only applies to individuals who have taxable income (known as 'relevant income') of greater than £130,000 in 2009/10 or the **two** previous tax years (i.e. 2007/08 and 2008/09). However, if contributions were paid between 22 April 2009 and 8th December 2009 then the income threshold is £150,000 (including for the previous two tax years).

For contributions made between 6 April 2010 and 5 April 2011 it will apply if taxable income exceeds £130,000 in 2010/11 or the **two** previous tax years (i.e. 2008/09 and 2009/10).

How 'relevant' is your income'?

The calculation of relevant income involves six distinct steps:

1. Identify **total taxable income** in the tax year. This will include earned income, investment income (interest, dividends etc.) and rental income.
2. **Add** in any occupational pension contributions made under the net pay arrangement, which are not otherwise treated as taxable income.
3. **Subtract** qualifying losses arising from trades or property.
4. **Subtract** pension contributions, up to a maximum of £20,000.
5. **Add** in the amount of any salary sacrifice started **after** 22 April 2009.
6. **Subtract** any charitable donations made under Gift Aid.

If the result is £130,000 or more (or £150,000 in respect of contributions made between 22nd April 2009 and 8th December 2009) the individual is subject to the special annual allowance. Otherwise they are not.

Pre-budget salary sacrifice/exchange arrangements

Salary sacrifice arrangements entered into before 22 April 2009 are not included in the calculation of relevant income. As long as these arrangements are not disturbed, they will continue to reduce tax and national insurance contributions during the anti-forestalling period up to 5 April 2011. However, if the employee is required to 'renew' the arrangement on an annual basis, HMRC may look carefully to see whether the 'renewal' is in fact effectively a new arrangement. A new salary sacrifice/exchange would be added back in to the calculation of relevant income and could cause the pension investor to exceed the £130,000 (or £150,000) relevant income limit.

If you are caught by the anti-forestalling rules, then the maximum contribution that you can make to a registered pension in 2009/10 and 2010/11, before incurring a tax charge known as the special annual allowance charge, will be limited to the higher of £20,000 (known as the 'special annual allowance') or pre 22 April 2009 regular contributions (known as 'protected inputs').

If you don't have protected inputs of more than £20,000, but have previously made 'irregular' contributions in any of the **three** previous tax years to the tax year in which you wish to make the new pension contribution, you may be entitled to make a contribution of more than £20,000 in either 2009/10 and/or 2010/11 and avoid the special annual allowance charge.

The special annual allowance is increased to the lower of £30,000 and the average of the irregular contributions paid over the three prior tax years to the extent that this would permit a contribution in excess of £20,000 in the current tax year without incurring the special annual allowance charge. Any existing regular contributions (protected inputs) would be deducted from the special annual allowance to determine the scope of any additional contribution.

For example, on 22 April 2009 Sarah had an existing pension plan to which she made regular contributions of £1,000 gross per month. She had also paid single payments as follows: 2006/07 - £52,000; 2007/08 - £35,000; 2008/09 - £72,000. The average of those single payments is £53,000, which means that the special annual allowance for 2009/10 is £30,000 (since £53,000 is higher than £30,000). After deducting the £12,000 of regular contributions, Sarah may make a further contribution of £18,000 gross and not be subject to a tax charge.

Planning options

So if you are caught by the income definition, what can you do if you want to make pension contributions of more than £20,000 in this or the next tax year? Well here are a few ideas that might work for you. Do bear in mind that HMRC has 'anti-avoidance' provisions for any 'artificial device or strategy' that claims to reduce or artificially depress relevant income below £130,000 (or £150,000 if applicable). If HMRC wants to continue this logic then clearly many MPs will be paying a lot more tax on those John Lewis 'benefits' they enjoy so take that threat as you will.

Relevant income between £130,000 - £149,999 - If you (or your employer) have not made any pension contributions in the current tax year, and you have relevant income of less than £130,000 in the two previous tax years, then a pension contribution of £20,000 will bring the 2009/10 relevant income below £130,000 and as such you may actually make a total pension contribution of up to 100% of earnings. For someone with earnings of, say, £130,000 and savings income making up the remainder, the tax relief on a £100,000 pension contribution is equivalent to 42%.

Protected inputs – If you and/or your employer were making regular (i.e. at least quarterly) contributions to a pension plan before 22 April 2009, or the contract was entered into before that date, make sure that you continue those contributions. If you transfer the pension plan to an alternative provider then the protected inputs will cease, although some providers will allow a partial (and substantial) transfer out of benefits but continue to receive regular contributions into the original plan. Check with the existing provider and get their response in writing.

Trading losses - Allocate trading losses from another business, possibly an LLP, against current or previous taxable income so that it brings taxable income below £130,000 (or £150,000 if applicable).

Charitable donations - If you have no trading losses but taxable earnings of less than £130,000 (or £150,000 if applicable) in 2007/08, then make a charitable gift (the Charitable Aid Foundation (CAF) account is ideal if you can't decide which charity to benefit just now) for the current or previous tax year, as this will reduce your income for pension forestalling rules by the amount of the contribution. The CAF will also accept donations of, or purchase at lower than market value, quoted investments and property if you don't want to use cash, but only for contributions in respect of the current tax year.

Defined benefits SSAS - If you are a company director, consider establishing a defined benefits small self administered scheme (SSAS). This may well allow a cash contribution higher than £20-30,000, if the cost of providing annual income at retirement age is higher. This is because the rules define the cash contribution for a pension scheme which provides defined benefits (a promise of a specific amount of pension in the future) as equal to ten times the benefit accrued. So an income benefit of £2,000 (with inflation protection and survivor's pension) will be treated as a £20,000 contribution, even if the actuarial cost (and the amount your company would contribute) might be, say, £50,000.



Employ your spouse – Since HMRC lost the case of ‘Arctic Systems’ and has twice dropped the expected blocking legislation due to human rights conflicts, it seems perfectly reasonable to carry out ‘income shifting’ by employing a spouse, together with an appropriate pension contribution. An employer (whether limited, LLP or sole trader) may contribute up to the annual allowance for an employee, regardless of how much income the employee is paid. Personal contributions are limited to the lower of 100% of earnings or the annual allowance (£245,000 for input periods ending in 2009/10).

A word of caution on this strategy: it would be sensible to ensure that the salary and pension paid to the spouse is ‘reasonable’ relative to the work being undertaken. In addition, the pension contribution paid by the employer will be subject to the ‘wholly and exclusively’ test to determine that it will be deductible for tax purposes. However, given the number of family members working for MPs and being paid nice salaries and accruing pension benefits in the generous parliamentary pension scheme I think HMRC is on shaky ground here!

Pay the tax charge - You could just pay a contribution of more than £20,000 (or more than £30,000 if you qualify) and accept the resulting tax charge that will arise on the basis that the tax relief will still be higher than 20%. For example, a higher rate taxpayer paying a £40,000 contribution in 2009/10 will receive tax relief of £16,000. However, the special annual allowance charge will be 20% of the excess contribution over the special annual allowance (assuming the allowance is the standard £20,000). Thus the charge will be £4,000 ((£40,000 - £20,000) x 20%). The effective tax rate achieved on the total contribution is, therefore, 30% ((£16,000-£4,000)/£40,000). Table 2 sets out the various permutations that generate 30% effective tax relief.

Table 2

Tax year	Special annual allowance	Pension contribution	Tax relief	Effective rate of relief
2009/10	£20,000	£40,000	£12,000	30%
	£30,000	£60,000	£18,000	30%
2010/11	£20,000	£60,000	£18,000	30%
	£30,000	£90,000	£27,000	30%

As we saw earlier in Table 1, even 30% relief is attractive if the rate of tax paid on the benefits is less than 40%, with an uplift of 19% if benefits are taxed at 20%.

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As well as the tax aspects, it's worthwhile remembering that pension funds are protected from creditors, especially in the current financial environment when many businesses are struggling and failing. Any individual in respect of whom a bankruptcy petition is presented after 29

May 2000, when the provisions introduced by the Welfare Reform and Pensions Act 1999 were implemented, will be covered by these provisions. Their pension arrangements **will not form part of their estate** and will be out of reach of the trustee in bankruptcy, subject to “excessive contributions” anti-avoidance provisions. Any pensions already in payment can be claimed.

In addition, prior to age 75, the value of pension benefits up to the lifetime allowance (or protected amount if higher), will not normally be subject to inheritance tax as long as the contributions were not made when the investor was in ill health. If combined with an appropriate trust, the pension fund can therefore be preserved for the family in the event of the investor's demise prior to drawing benefits.

Obtaining 30% tax relief therefore might be acceptable if pension savings are desirable as a means of holding capital in the context of your overall financial plan.

Alternatives to registered pensions

So what can one do if further pension contributions aren't possible? Well there are a number of solutions that might fit the bill but do remember that there is no perfect solution and that it is likely that a combination of ideas will be suitable. We've covered most of these ideas in previous editions of TSR.

Protected EIS – in the past we have explained how these very low risk portfolios work. The main benefit is that tax relief of 20% is given on the gross investment of up to £500,000 for this or the previous tax year. After three years the EIS provider aims to return the investor's original capital. The net return is in excess of 7% per annum, equivalent to over 14% for a 50% tax payer or 12% for a 40% tax payer.

Secure VCT – similar to protected EIS, these funds invest in low risk commercial ventures which aim to return the original capital invested after a five-year period. Tax relief is provided at 30% up to £200,000 per tax year. The net return is in excess of 7.85% per annum, equivalent to over 15% for a 50% taxpayer or over 13% for a 40% taxpayer.

Affordable housing partnerships – these exploit income tax relief given to the conversion and refurbishment of commercial property to 'affordable' rented residential property. The associated risks are manageable given that the arrangement is asset-backed and the low amount of associated borrowing is determined by the achievable rental income.

Employer funded retirement benefits schemes (EFRBS) – we've previously explained how these unregistered pension schemes work. They are most suitable where contributions are likely to be at least £250,000. There is no immediate income tax or national insurance contribution paid by the employee. The company will receive a corporation tax deduction on the contribution, deferred until the time that benefits are **paid** (but not necessarily taxed), but the net amount (between 72-81%) is immediately available to invest and income and gains arising on non-UK domiciled funds and assets will roll up tax-free (other than withholding taxes).

If you are in a partnership you can also benefit from EFRBS by the introduction of a corporate member, which would act as the sponsoring employer of the EFRBS.

Tax on benefits depends on the residence and domicile basis of the member at the time. A UK resident and domiciled member will pay income tax on 90% of any pension (i.e. 18%, 36% or 45% from April 2010). Lump sums are taxable in full. Clearly, non-UK residence when taking benefits looks attractive, as the company can obtain the corporation tax deduction even if the member has not paid income tax.

As long as the scheme is properly constituted and established in the right way, the fund will not form part of the member's estate for inheritance tax purposes and can be used to provide benefits to the member's spouse and wider family.

Employee benefit trust (EBT) – similar to EFRBS but more of a deferred remuneration scheme, which must be available to all staff. Corporation tax is given when benefits are **paid and taxed** on the employee, and this can be at any age. However, the EBT can provide interest-free loans to members, which would be taxed as a benefit in kind at HMRC's published official interest rate. These are usually most suitable for larger organisations.

Not caught by the 'relevant income' conditions?

If you are not subject to the anti-forestalling measures then here is a list of planning points to consider prior to 6 April 2011:

- Make personal contributions up to 100% of earnings to the extent that they receive tax relief at 40% (or 60% if your income is between £100,000-112,950 in 2010/11);
- Agree any future bonus or remuneration be paid to your pension scheme by your employer, up to the annual allowance of £245,000 in 2009/10 or £255,000 in 2010/11. Employer contributions are not subject to the employee's requirement that they have corresponding earnings to justify the contribution but they do need to be reasonable and not part of a post 22 April 2009 salary 'sacrifice' arrangement;
- If income is below £130,000 in the current and previous two tax years, **before** any salary sacrifice/exchange occurs, it will continue to be attractive as a means of reducing tax and national insurance contributions.
- Where a) cash is tight, b) you have assets that have an uncrystallised loss that you would like to carry forward or c) you have unrealised capital gains that you would prefer to be taxed at the currently beneficial rate of 18% (after annual exemption and current year losses) consider making pension contributions 'in specie' i.e. by transferring property or investment funds/holdings to the pension. As well as crystallising the loss or gain on the asset transferred to the pension, you will receive tax relief at your highest rate. Property can be part-owned personally and by your pension scheme so, if needed, the contributions could be straddled over the current and next tax year.

There is a lot to these pension changes and clearly each person will have different circumstances, objectives and opinions that point to different solutions. However, don't let the perceived complexity stop you from keeping hold of as much of your hard earned wealth as possible.

For further information please get in touch with your usual Bloomsbury contact, telephone 0207 194 7830 and ask for a member of the wealth team or alternatively e-mail info@bloomsburyfp.co.uk.

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