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Pensions 2011/12
- the changes explained

Every so often UK governments tackle the thorny issue of the amount of tax relief which it is appropriate to allow for contributions into a pension scheme and the extent of taxation when the funds are withdrawn from a scheme when the taxpayer retires. The Finance Bill 2011 sets out new limits on the amount of tax relief that may be available but also introduces relaxations to the system of accessing the funds in retirement.

This briefing sets out the main features of the new regime including points to consider in planning for retirement and taking your money in retirement.

The recent history of tax relief for pension contributions

The last fundamental changes to the tax regime for pensions were introduced from 6 April 2006. No financial limits were set on either the maximum amount which could be invested in a pension scheme in a year or on the total value within pension funds. However, controls were put in place to control the amount of effective tax relief and exemption which was available. In outline:

- An individual obtains tax relief on contributions up to the higher of:
    - 100% of UK relevant earnings or
    - £3,600.
- Employer contributions to registered schemes are generally deductible for tax purposes, with statutory provision for spreading abnormally large contributions over a period of up to four years.

The annual allowance (AA)

Up to and including the 2010/11 tax year, the AA determined the maximum amount which could be invested into pension funds without triggering an immediate tax charge. It applied to the combined contributions of employee and employer. The AA was £255,000 for 2010/11.

The AA is still with us but the amount of the allowance and the effect of exceeding the AA have been changed with effect from 2011/12.

So how is the AA changing?

This is now set at £50,000. Any gross contributions in excess of the AA will be charged to tax on the individual as their top slice of income. Contributions include contributions made by an employer.

The rules apply for the 2011/12 tax year and, in particular, to pension input periods (PIPs) ending in the tax year 2011/12 but beginning earlier.

The stated purpose is to discourage pension savings in tax registered pensions above the AA. It is expected that most individuals and employers will actively seek to reduce pension savings to below the AA, rather than fall within the charging regime.

Example – director/shareholder

Ben is a director/shareholder of a family company and has taxable income of £120,000 in 2011/12. For several years, the company has been paying monthly contributions into a pension scheme for his benefit totalling £60,000 per year. He does not make any pension contributions himself. The charge will be:

Pension contribution in 2011/12	£60,000
Less AA	(£50,000)
Excess	£10,000
Taxable at 40%	£4,000

Example – self employed

Anthony, who is self employed, has taxable income of £120,000 in 2011/12. He makes personal pension contributions of £50,000 net in 2011/12. His AA is £50,000. He has made similar contributions in the previous three tax years.

Gross pension contribution	£62,500
Less AA	(£50,000)
Excess	£12,500
Excess taxable at 40%	£5,000

Anthony will have had tax relief on his pension contributions of £25,000 (£62,500 x 40%) and now effectively has £5,000 clawed back.

A point to watch - sort out your PIPs

A PIP may not coincide with the tax year and if a person has several schemes, each scheme can have a different PIP. Normally a PIP runs for a 12 month period.

It is essential to know what the PIP is for each pension scheme before significant pension contributions are made into any particular scheme. For example, in pension scheme A, the PIP may coincide with the tax year, whilst in pension scheme B, the PIP is the 12 months to 31 December.

The relevant contributions that need to be considered for the impact of the AA charge in 2011/12 will be for:

Scheme A - 6 April 2011 to 5 April 2012

Scheme B - 1 January 2011 to 31 December 2011

Special transitional rules may apply to pension contributions made before 14 October 2010 that fall into 2011/12 PIPs.

Carry forward of unused AA

To allow for individuals who may have a significant amount of pension savings in a tax year but smaller amounts in other tax years, a carry forward of unused AA has been introduced.

The carry forward rules apply if the individual's pension savings exceed the AA of £50,000 for the tax year. The AA for the current tax year is to be treated as increased by the amount of the unused AA from the previous three tax years.

Unused AA carried forward is the amount by which the AA for that tax year exceeded the total pension savings for that tax year.

This effectively means that unused AA of up to £50,000 per year can be carried forward for the next three years.

Importantly, no carry forward is available in relation to a tax year preceding the current year unless the individual was a member of a registered pension scheme at some time during that tax year.

An amount of the excess for an earlier tax year is to be used before that for a later tax year.

When looking at whether there is unused AA to bring forward from 2008/09, 2009/10 and 2010/11, the AA for those years is deemed to have been £50,000.

Example

Bob is a self employed builder. In the previous three years Bob has made gross contributions of £40,000, £20,000 and £30,000 to his pension scheme. As he has not used all of the deemed £50,000 AA in earlier years, he has £60,000 unused AA that he can carry forward to 2011/12.

Together with his current year AA of £50,000, this means Bob can make a gross contribution of £110,000 in 2011/12 without having to pay a tax charge.

Members of defined benefit schemes

In a defined benefit scheme, individuals accrue a right to an amount of annual pension when they retire. This right does not necessarily equate with the contributions made by themselves and their employers. Therefore the rules require a notional value of contributions to be computed. The notional contributions should reflect the amounts needed to be invested in a money purchase scheme to deliver the extra annual pension accruing in a defined benefit scheme. A 'flat-factor' method is to be used and is set at 16.

The 16 factor means, broadly, that an increase in annual pension benefit of £1,000 would be deemed to be worth £16,000. So if an individual is in a final salary defined benefit scheme and has a promotion resulting in a pay rise, the deemed contribution may be very high.

In some situations, the individual will be able to require the tax bill arising on the AA charge to be met by the pension fund (with a commensurate reduction in the pension entitlement). This also applies to defined contribution schemes.

What else is changing?

Changes are being made to:

- amounts that can be tax efficiently accumulated in all the pension schemes for an individual
- requirements to buy an annuity
- the inheritance tax effects of pension schemes.

The lifetime limit

The 'lifetime limit' sets the maximum figure for effective tax-relieved savings in pension funds.

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(s) exceeds the limit there is a tax charge of 55% of the excess if taken as a lump sum, or 25% if taken as a pension.

The lifetime limit sets the maximum figure for tax-relieved savings in the fund and rose to £1.8m for 2010/11 and remains at this figure for 2011/12. The government has announced that the limit for 2012/13 will be reduced to £1.5 million.

Those with savings above £1.5 million or who believe the value of their pension pot will rise to above this level through investment growth without any further contributions or pension savings, will be able to apply for a new personalised lifetime allowance of £1.8 million, providing they cease accruing benefits in all registered pension schemes before 6 April 2012.

Requirement to buy an annuity

The obligation for members of registered pension schemes to secure an income, usually by buying an annuity, by age 75 has been removed with effect from 6 April 2011.

As a consequence, changes have been made to other aspects of taking an income and treatment of lump sums.

In summary, from 6 April 2011:

- An income from a defined contribution scheme can be taken at any time from the age of 75 either by purchasing an annuity or as a 'drawdown pension' (a pension fund where the option to take a drawdown pension is referred to as a 'drawdown fund').
- Drawdown pension replaces the 'unsecured pension' and 'alternatively secured' pensions.
- The maximum withdrawal of income that an individual may make from most drawdown funds will be capped at 100% of the equivalent annuity that could have been bought with the fund value.
- There will be no requirement to take a minimum pension.
- The ability to take a 25% tax free lump sum the first time pension benefits are accessed remains.
- Individuals who can demonstrate that they have secure pension income for life of at least £20,000 will have unrestricted access to receive their drawdown fund as pension income. This is known as the 'flexible drawdown'. The secure income can be made up of state pension and/or occupational pension and/or an annuity from a pension scheme.

What happens if the person dies before accessing their pension fund?

In summary the old rules were:

- lump sum death benefits relating to individuals who died before reaching age 75 and before taking a pension were tax free
- lump sum death benefits relating to individuals who died before reaching age 75 after taking a pension were liable to tax at 35%
- No lump sums could be paid after the member had reached the age of 75.

Under the new regime:

- most of the rules preventing registered pension schemes from paying lump sum benefits after the member has reached the age of 75 are removed
- lump sum death benefits relating to individuals who die before reaching age 75 and before taking a pension remain tax free
- the tax rate for all lump sum death benefits will be 55%
- unused drawdown pension funds of a member who dies with no living dependants may be donated tax free to a charity.

A point to note

The main cost to the individual of the increased flexibility offered in the deferral of taking pension benefits is the 55% charge on lump sum death benefits. The charge will not however apply to death benefits for those who die before age 75 without having taken a pension.

Inheritance tax (IHT) and drawdown

With effect from 6 April 2011, IHT will not typically apply to drawdown pension funds remaining under a registered pension scheme, including when the individual dies after reaching the age of 75.

A charge could have arisen in some circumstances under the general charging provisions of IHT. In particular, where an individual was entitled to access their pension fund but chose to defer because of severe ill health. The possibility of this charge arising has been removed from 6 April 2011.

If you require further information about obtaining advice on the matters covered in this briefing please do not hesitate to contact us.

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