

Pensions Update: May 2009

Pension benefits for high earners: impact of the recent budget

Briefing note

Author: Kris Weber

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In a nutshell

Changes to the system for obtaining tax relief on pension contributions, announced as part of last month's Budget, have the potential to seriously impact upon the amount of pension provision that can be made tax-effectively for senior executives and other high earners. Employers and trustees should be aware of the potentially far-reaching implications of the change in the law: although tax is ultimately a matter for the affected individual, the prospect of having a disgruntled senior member of staff is likely to be particularly unappealing to those involved with sponsoring or operating pension schemes.

Background

One of the announcements made in the April 2009 Budget was that, from April 2011, 'high earners' (those with an income of £150,000 per annum or more) will only receive basic rate tax relief on pension contributions, rather than the higher rate relief they enjoy at present. This change will apply on a tapered basis to those with earnings between £150,000 and £180,000, and in full above that higher figure.

Furthermore, to prevent such people stuffing their pension schemes with cash now (in order to get as much higher rate relief as possible before the law changes), the Government has also announced the introduction of "anti-forestalling provisions" which limit, with immediate effect, the amount of pension contributions that 'high earners' can make in a tax-effective manner.

The changes are outlined in the current Finance Bill, which will eventually become the Finance Act 2009. It in turn will make changes to the Finance Act 2004, which sets out the tax regime applicable to pension schemes on/after A-Day. It cannot be said with absolute certainty what the law will look like, until the Finance Bill has received Royal Assent. However, for the purposes of this note, we take the Bill as it currently stands.

Impact

The new provisions, which take effect as from 22 April 2009, have the potential to seriously impact upon the pensions options that are open to senior executives or other 'high earners' on a termination of employment. They also have the ability to hamper the provision of pension benefits to newly-recruited senior employees, and in industries where it is customary for annual bonuses to be paid by recipients into a pension scheme.

Who will be caught by the change in the law?

Anybody who:

- has an income of £150,000 or more during the tax year concerned or either of the previous two tax years;
- increases their pension contributions or benefits in a manner that is outside their 'normal pensions savings pattern'; and
- makes total pension savings in that year with a 'capital value' of £20,000 or more.

'Income' for these purposes includes bonuses; any earnings surrendered pursuant to a salary sacrifice arrangement; and un-earned income, for example from property rentals.

A benefit augmentation in a final salary scheme, and a large contribution into a money purchase scheme (including a personal pension or stakeholder), will fall outside someone's 'normal pensions savings pattern'. So too will the provision of benefits under a scheme to a newly-recruited senior executive, if they are in excess of what is normally provided to the employer's staff; and it is conceivable that increases in the value of benefits arising from large salary rises may also be caught. Putting a large annual bonus into a pension scheme will also have significant tax implications.

The 'capital value' of any pensions savings is, in a money purchase arrangement, the amount of contributions made into the scheme. In a salary-related scheme it means the amount by which the member's annual pension has increased as a result of the additional benefits granted or earned, multiplied by ten.

What happens if the new limits on pension savings are breached by a high earner?

The individual will be subject to a 20% tax charge, on the amount by which (i) the capital value of their pensions savings in the year in question exceeds (ii) £20,000.

The effect of the tax charge is to turn the higher rate (40%) tax relief s/he would otherwise have received into basic rate (20%) tax relief. However, the 20% tax charge will be collected as a lump sum from the individual, via his/her year-end tax return. 'High earners' whose pensions savings are unwittingly increased by more than the permitted amount may, therefore, many months down the line, find themselves in for a nasty shock!

Although there is no obligation upon employers or pension trustees to make their high-earning staff aware of the impact of any extraordinary pension benefits they may be awarded, good employee/member relations would suggest that they at least be forewarned of the prospect of tax implications (and the need to take their own advice) prior to any such benefits being granted to them.

Further points to note

Pension scheme administrators will be given the ability to refund to a member any contributions that s/he made without realising that higher rate tax relief was unavailable.

Where additional benefits are earned as a result of changes to the rules of a scheme, these will not be caught by the new tax charge if the individual was in membership on 22 April 2009 and the change applies to at least 50 active members of the scheme.

Similarly, new pensions saving by an individual – where at least 20 other members of the scheme accrue benefits on the same basis – will also not be subject to the tax charge.

More information

Kris Weber

+44 (0)20 7203 5077

kris.weber@charlesrussell.co.uk

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