Pensions and Tax Changes for Senior Employees

Senior employees will pay more tax following the cuts to the Annual Allowance announced in the 2015 Summer Budget unless action is taken. This paper sets out the key changes announced in the 2015 Summer Budget as it affects members, employers and trustees, with some thoughts on potential actions to address their impact.

The tax limits on pension savings only used to apply to the very highest earners. In his 8 July 2015 Budget, the Chancellor announced further changes to the Annual Allowance (AA) which could lead to many more individuals losing large portions of their pension savings to the taxman. The Chancellor also announced a Green Paper starting a consultation on pensions tax relief.

Annual Allowance reduced for "high earners"

For people earning more than £150,000, the standard AA will be earnings related and will reduce by £1 for every additional £2 of taxable income above £150,000. The minimum AA will be £10,000 which is equal to the Money Purchase Annual Allowance (MPAA) for people who have used the new drawdown flexibilities to access their pension savings.

TAXABLE INCOME

Less than £150,000	£40,000*
£150,000 to £210,000	Earnings related, between £40,000 and £10,000*
Greater than £210,000	£10,000

*A member may still be subject to the MPAA of £10,000.

For example, Emily earns £200,158 and so has a standard AA of £14,921 (i.e. 40,000 -0.5 x (200,158 – 150,000)).

Taxable income used to determine "high earners"

Two new pay definitions have been introduced into the pension tax environment.

Adjusted Income: This is the income amount used to calculate a member's AA for the tax year. This is broadly total taxable income over the tax year, plus the value of any pension benefits built up over the year. Pension benefits are calculated in the same way as for the Annual Allowance calculation for both defined contribution and defined benefit members i.e. the Pension Input Amount.

This does mean, however, that some people may be deemed to be a "high earner" in a tax year due to a one-off event in that year. For example, if they receive a large redundancy payment.

For example Keith has a salary of £100,000 and also receives a bonus of £20,000 on 5 April 2017. Hence his total taxable income is £120,000 for the 2016/17 tax year.

He is a member of a defined benefit scheme, and the value of the increase in the benefit is £35,000 in the tax year. Hence his Adjusted Income is £155,000 and so he has an AA of £37,500.

Threshold Income: This is broadly taxable income before any member contributions or salary sacrifice is deducted, and does not include the value of pension benefits. The reduced AA will not apply for someone with income less than this threshold (which is set initially at £110,000).

One difficulty of the new regime is that the AA for a tax year is dependent on the person's taxable income for that tax year. As a result, some people will not know with any certainty what their AA is, and hence the level of tax efficient savings they can make to a pension scheme, until after the end of the tax year.

For example Steve has a salary of £100,000 and receives a bonus of £9,000. His total taxable income is £109,000 and so his income is below the income threshold. Hence he has an AA of £40,000 irrespective of the level of his pension savings over the tax year.

Action: many more individuals will not be caught by the AA. Employers need to assess who may be affected, and determine where pensions sit within the overall reward package as alternatives may exist in which individuals can be remunerated in a more tax-efficient manner. In addition, with the increasing blurring of the boundary between pensions and ISAs, employers should consider holistic saving solutions for their employees.

It is also important for employers to communicate these changes to employees, and to ensure that employees have the tools to make informed decisions that maximise outcomes (rather than just minimise tax).

Confirmation of Lifetime Allowance reduction, and protections available

It was confirmed that the Lifetime Allowance will, as announced in the March 2015 Spring Budget, reduce to £1m with effect from 6 April 2016. In addition, the Government has confirmed that new forms of protection will be available to people potentially affected by the reduction to the Lifetime Allowance. Further details of these protections, which are expected to be similar to Individual Protection 2014 and Fixed Protection 2014, will be announced shortly.

Consultant launched on Pensions Tax Relief

A Green Paper has been published on whether there is a case for reforming pensions tax relief or whether it would be best to keep the current system. This is less than 10 years since the big pensions tax reforms of "A-day" in 2006. Alternatives suggested include moving to the Taxed-Exempt-Exempt system that applies to ISAs as well as less radical changes including further adjustments to the Lifetime and Annual Allowance.

The Government presents the consultation against a background of increased longevity and the changing nature of pensions provision away from DB schemes towards DC schemes. It considers that any changes should result in a system that is simple and transparent, sustainable (for the public finances) and allows individuals to take personal responsibility for ensuring they have adequate savings for retirement. It also wants to build on the early success of auto-enrolment in encouraging pension savings.

Please contact your usual 44 Consultant for further information.

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