



Pensions

Higher rate tax relief on pension contributions - pitfalls for employers

As reported in TLT's recent update on the Chancellor's Budget of 22 April 2009, from 6 April 2011, any employee with an annual taxable income of £150,000 or more will no longer be able to claim higher rate tax relief on pension contributions. Instead, such relief will be reduced on a tapering basis with the effect that those earning more than £180,000 will only receive basic rate pension tax relief.

The Government has also announced certain transitional arrangements which prevent high earners from changing their regular pension contribution patterns before April 2011, in an attempt to avoid the new legislation. These anti-forestalling provisions introduce a "special annual allowance charge", where individuals with incomes of more than £150,000 in the current or previous two tax years:

- increase their regular pension contributions on or after 22 April 2009 or make non-regular contributions; and
- whose total pension contributions (employer and employee) exceed £20,000.

The effect of the special annual allowance charge is to restrict available tax relief to the basic rate. This means that if an employee earning £150,000 or more has regular pension savings exceeding £20,000 for the tax year 2009/10, tax relief on any increased pension savings made on or after 22 April 2009 will be limited to 20%.

Liability for the special annual allowance charge arises through self-assessment and not through payroll. Therefore, it is primarily up to individuals to seek advice on their personal circumstances. However, there are a number of pitfalls for the

unwary employer, over which particular care should be taken.

Identifying those employees whose annual taxable income exceeds £150,000

The relevant income used to assess whether an employee's annual taxable income exceeds £150,000 does not simply include salary paid by an individual's employer. It includes all income chargeable to income tax and will, therefore, cover self-employed earnings, income from personal and occupational pensions, interest on most savings and dividends and rental and trust income. Employers are unlikely to have such detailed information about an employee's other sources of income so it can be seen that many employees whose basic salary is less than £150,000 could also be caught by the special annual allowance charge.

If employers decide to provide guidance to employees in this area, perhaps, for example, to those who participate in salary sacrifice or flexible benefit arrangements, they should ensure that they write to all potentially affected employees and not simply those whose salary exceeds £150,000 per annum. As always, in these

circumstances, care must be taken to ensure that employers are not providing individuals with financial advice.

Salary sacrifice

Her Majesty's Revenue & Customs (HMRC) has confirmed that employers and employees will not be able to use salary sacrifice to avoid the impact of the new measures. For individuals in these arrangements, an amount equal to the employer's pension contribution will count as "relevant income", although salary sacrifice arrangements in place prior to 22 April 2009 are protected.

Nevertheless, salary sacrifice will continue to be an attractive option for certain high-earning employees. For those employees earning between £100,000 and £150,000, the income tax personal allowance will be abolished on a sliding scale from 6 April 2010. It will be reduced by £1 for every £2 that a person's income exceeds £100,000. This means that, at current rates, any income between £100,000 and £112,950 will be subject to tax at 60%. Therefore, employees in this earnings bracket will particularly benefit by reclaiming 60% tax if they sacrifice earnings above £100,000 into their pension.

Even for those employees whose relevant earnings exceed £150,000 a year, salary sacrifice could still be an attractive option, given the potential savings in national insurance contributions. Employers currently make a 12.8% national insurance saving on the amount sacrificed. Employees earnings up to £44,000 currently pay national insurance at a rate of 11%; above that, employees pay national insurance at 1%. However, national insurance contributions are due to increase by 0.5% for

employers and employees from 6 April 2011. Salary sacrifice may therefore look attractive to the higher earner looking to offset some of that increase, particularly if their employer is willing to pass on some or all of the employer's national insurance savings as additional contributions to the employee's pension.

Annual or infrequent pension contributions

As the legislation is currently drafted, individuals who make contributions into their pension annually or more infrequently will fall foul of the special annual allowance charge. This is because normal ongoing contributions to pension are only protected if they were paid on a quarterly or more frequent basis before 22 April 2009.

Pension payments from annual bonuses or irregular contributions made by the self-employed or directors will therefore become less tax efficient. However, in its Ministerial Statement dated 23 April 2009, the Government recognised that those with less regular contribution patterns may be adversely affected and are inviting views as to how this group can be protected without compromising its objective of restricting pension tax relief for those on high incomes.

Termination packages

The first £30,000 of a non-contractual lump sum paid on termination of an employee's employment will not count towards the £150,000 relevant income threshold and neither will statutory redundancy payments. However, it has become common practice for high earners with large termination packages to elect to have all or part of any

termination payment over £30,000 paid into their pension. Where this payment exceeds £20,000 and the employee is not electing to draw his pension in the current tax year, he will be subject to the special annual allowance tax charge.

Even if the employee is nearing retirement and intends to draw his pension benefits after termination, he will be subject to the charge unless the scheme in question is a defined benefit arrangement (not a defined contribution arrangement) or he is retiring due to ill-health. HMRC are being asked to clarify whether the legislation will be changed to ensure consistency of treatment between defined benefit and defined contributions arrangements. However, even if changes are made to the legislation as drafted, it is clear that the tax efficiency of making large payments into a high earners' pension on termination has been greatly diminished.

Conclusions

The changes announced in the Budget have undoubtedly made pensions less tax efficient for the higher earner. Employers will need to become more inventive in the design of their remuneration packages if they are to continue to attract and retain the best staff. Tax approved option plans such as Enterprise Management Incentive plans, Company Share Option Plans ("CSOP") or ShareSave plans, or share plans such as the Share Incentive Plan may become increasingly attractive.

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