CHAPTER 29

PENSION SCHEMES – FURTHER ASPECTS

29.1 Annual Allowance charges – advanced aspects

The annual allowance is the amount by which pension savings in a registered pension scheme (the "total pension input") are allowed to increase in the pension input period, ending in the tax year. The first pension input period **starts on the date contributions are first made** to the scheme or rights start to accrue in the case of a defined benefit scheme and **ends on the anniversary of that date.** Subsequent input periods end on the anniversary date, although the scheme administrator can change the date. The pension input period **cannot exceed 12 months** and there must be one pension input period ending in every tax year. FA 2004, s.238

Increases in the total pension input amount for the pension input period ending in the tax year over and above the annual allowance will be subject to a tax charge of 40%. The annual allowance for 2010/11 is £255,000. The charge is payable by the individual member and will be declared on the self-assessment return.

Annual allowance charges are levied on both money purchase ("defined contribution") schemes and on final salary ("defined benefit") schemes.

Defined contribution schemes

In the case of a defined contribution scheme, the pension input amount is the total of contributions eligible for tax relief paid by or on behalf of an individual plus any employer contributions.

Illustration 1

An employee has earnings of £1.2m in 2010/11. He contributes 15% of his earnings (evenly throughout the year as he has for many years) to his occupational money purchase scheme during the pension input period ending in the tax year. His employer contributes £1 for every £2 contributed by the employee.

The annual allowance charge in 2010/11 is:

	£
Employee:	180,000
Employer: £1.2m x 15% x ½	90,000
Pension input	270,000
Annual allowance charge: £(270,000 – 255,000) @ 40%	**£6,000**

Defined benefit schemes

The position is more complex for final salary ("defined benefit") schemes. In a final salary scheme, the benefits an employee can take from the scheme are determined by the employee's final remuneration, the years of service the employee has with that employer and the scheme accrual rate. FA 2004, s.234

The accrual rate is the fraction of final remuneration for each year of service a scheme may provide in the form of a pension. Many defined benefit schemes work to a target of providing a maximum pension of 2/3rds of final remuneration for someone who works 40 years for the same employer. In this case, the scheme accrual rate is likely to be $1/60^{th}$, i.e. for each year of service the employee is entitled to $1/60^{th}$ of their final remuneration.

Illustration 2

Emma has been employed by Knott plc for 30 years. If her final remuneration is £40,000, she will have a maximum pension entitlement of 30/60 x £40,000 = £20,000 per annum.

If Emma had worked for Knott plc for 45 years, the maximum number of years of service taken into account would be 40, giving her a maximum pension entitlement of 40/60 x £40,000 = £26,667 i.e. 2/3rds of final remuneration.

Some schemes may provide a more generous accrual rate such as $1/30^{th}$, which allows a maximum pension of 2/3rds of final remuneration to be obtained after 20 years of employment.

Therefore in a final salary scheme, contributions made by the employer and the employee are irrelevant in determining the employee's retirement benefits. If the scheme is "under-funded" (i.e. the money in the pension fund is not sufficient to meet the employee's pension entitlements) it is the employer who must make up the difference. For this reason, most occupational pension schemes are "money purchase" schemes, as such schemes give the employer no exposure if the fund under-performs.

Contributions by employees to final salary schemes are normally a fixed percentage of annual remuneration as determined by the employer.

In the case of a **defined benefit** scheme, the pension input amount is the amount of any **increase in value of the individual's rights** under the scheme during the pension input period ending in the tax year. The value of the individual's rights for this purpose is taken to be the maximum annual pension entitlement multiplied by ten. It is therefore necessary to calculate this value at the beginning and end of the pension input period.

Illustration 3

Nancy is a member of her employer's final salary scheme. At the beginning of the pension input period ended in 2010/11, Nancy had 15 years of service and her salary was £75,000. This increased to £120,000 by the end of the period when she was promoted. By the end of the pension input period, she had been with the employer for 16 years. The pension accrual rate of the scheme is 1/30, with a maximum of 20 years service.

We calculate the annual allowance charge as follows:

Value of rights at end of pension input period	£
16/30 x £120,000 x 10	640,000
Less:	
Value of rights at start of pension input period	
15/30 x £75,000 x 10	(375,000)
Pension input amount	£265,000
	£
Pension input amount	265,000
Less: annual allowance	(255,000)
	£10,000
Annual allowance charge: £10,000 x 40%	£4,000

29.2 Special annual allowance charge - introduction

In the 2009 Budget, the Government announced its intention to **restrict tax relief** for pension contributions where contributions are made to a registered pension scheme by individuals with income of £150,000 or more. This restriction may apply from 6 April 2011, although the current government is reviewing the proposals.

Therefore legislation was introduced to prevent individuals who will be affected by the proposed changes from increasing their pension provision **in excess of their normal regular pattern.** The new rules applied from 22 April 2009 to individuals whose income is **£150,000 or higher,** who changed their normal ongoing regular pension savings on or after that date and whose total pension input amount **exceeds the special annual allowance** which is generally £20,000 in a tax year. From 9 December 2009, the rules were extended to individuals with income of £130,000 or higher, who changed their normal regular pensions savings on or after 9 December 2009.

FA 2009, Sch 35

FA 2009, Para 2 Sch 35

FA 2009, Para 1 Sch 35

For a member of a defined contribution scheme, where the individual's regular (i.e. quarterly or more frequently) pension savings already **exceed the special annual allowance,** the full amount of any additional contributions will be treated as excess contributions. Where regular pension savings are below the special annual allowance, only the total contribution in excess of the allowance will be an excess contribution.

For a member of a defined benefit scheme, there will not be a special annual allowance charge provided the terms of the scheme rules have not been materially altered.

The excess contribution was **charged to tax at 20% in 2009/10.** For 2010/11, the excess is charged at 0% if the aggregate of the excess and the individual's income is below the basic rate limit. It is charged at 20% to the extent that the aggregate falls within the higher rate band and is otherwise charged at 30%. FA2009, Para 1(8) Sch 35

The rules in relation to the existing annual allowance charge have not changed. In order to prevent a double charge to tax, any excess contribution subject to the annual allowance charge will not be subject to the special annual allowance charge. FA2009, Para 1(9) Sch 35

Illustration 4

Sarah earns £193,525 per annum and is a member of a personal pension scheme. She has contributed £1,200 per month to the pension since April 2006. From May 2010 she decided to increase the level of her contribution to £1,800 per month. Sarah has no other income in 2010/11. Her special annual allowance is £20,000.

Her income tax liability will be calculated as follows:

	£
Salary	193,525
Less: Personal allowance	(Nil)
Taxable Income	£193,525
Tax	£
63,650 @ 20% (W1)	12,730
112,600 @ 40%	45,040
176,250	
17,275 @ 50%	8,637
	66,407
Add:	
Special annual allowance charge (W2)	1,875
Total liability	**£68,282**

Workings

(1)

Original basic rate limit	37,400
Add: (1,200 +(11 x 1,800)) x $\frac{100}{80}$	26,250
	£63,650

(2)

Original higher rate limit	150,000
Add: (1,200 +(11 x 1,800)) x $\frac{100}{80}$	26,250
	£176,250

(2)

Total pension savings		
(1,200 +(11 x 1,800)) x $\frac{100}{80}$		26,250
Less: higher of		
- regular savings (1,200 x $\frac{100}{80}$) x 12	£18,000	
- special annual allowance	£20,000	
		(20,000)
Excess contribution		£6,250
£6,250 @ 30%		£1,875

The effect of the special annual allowance charge is to reduce the tax relief on the excess contribution to 20%.

29.3 Special annual allowance charge – calculation of income

The special annual allowance charge generally only applies where the individual is a high income individual for the tax year i.e. an individual's relevant income is £130,000 or more. However, an individual will also be considered a high income individual in 2010/11 if their **income in either of the two preceding tax years was £130,000 or more.** FA2009, Para 2(2) Sch 35

Income for this purpose is calculated by taking the **total income** for the tax year (before any relief for pension contributions paid under a net pay scheme) and **deducting any allowable deductions and reliefs,** including relief for charitable donations. Total **pension contributions** eligible for relief **up to a maximum of £20,000** are then deducted in order to arrive at relevant income. FA2009, Para 2(1) Sch 35

29.4 Special annual allowance – calculation of the allowance

The special annual allowance is usually £20,000. However, an individual may have a special annual allowance of up to £30,000 if contributions have been made to a money purchase pension scheme infrequently, i.e. not on a monthly or quarterly basis, in any of the tax years 2006/07 to 2008/09. FA2009, Para 17 Sch 35

If the average of the infrequent contributions for the three years exceeds £20,000 but is less than £30,000, the special annual allowance is equal to the average. If the average contribution exceeds £30,000, the special annual allowance is £30,000.

29.5 The Lifetime Allowance – advanced aspects

A lifetime limit is placed on the total value of pension benefits that an individual can benefit from without triggering a tax charge. This limit is called a lifetime allowance. The lifetime allowance is £1.8m for 2010/11. FA 2004, s.214

Where the capital value of the pension benefits at retirement (or when benefits are taken, if sooner) exceeds the lifetime allowance, a tax charge will be levied on the excess. This is called a "lifetime allowance charge". The purpose of the charge is to recover the excess tax reliefs the fund has benefitted from, both in respect of relief for initial contributions and the tax free growth of the fund. If the excess is taken as a lump sum, the tax charge is at 55%. If the excess is used to purchase a pension, the tax charge is at 25%. The annual pension income is thereafter taxed as non-savings income. FA 2004, s.215

Illustration 5

Harvey retires on 31 January 2010 aged 60. At that point, the capital value of his pension benefits is £2.9m. This exceeds the lifetime allowance of £1.8m in 2010/11, so the excess will be charged to tax.

We split the pension fund into an "authorised fund" of £1.8m and an "unauthorised fund" of £1.1m. The authorised fund receives tax privileges (such as a tax free lump sum). The unauthorised fund is fully taxable.

Authorised fund (£1.8m)

Up to 25% (i.e. £450,000) can be taken as a tax-free lump sum. The remainder of the fund will generate an annual pension income which will be taxed at the taxpayer's marginal rate when it is paid.

Authorised fund
£1.8m

Lump sum (max 25%)	Fund for pension
£450,000	£1,350,000
Tax free	*Annual pension income taxable*

Un-authorised fund (£1.1m)

The capital excess of £1.1m will either be taxed at 55% if taken as a lump sum, or taxed initially at 25% if taken as pension income, then thereafter at the taxpayer's marginal rate as and when the income is actually paid.

Un-authorised fund
£1.1m

Lump sum (no restriction)	Pension income
Tax @ 55%	*Tax capital fund @ 25%*
	Taxed again when annual income paid

A lump sum is taxed at a higher rate to take account of the fact this amount will not suffer any further tax charge, whereas the balance used to pay out pension income will in effect be taxed again when the individual receives the pension income.

29.6 Taxpayers with more than one pension

The annual allowance applies to the aggregate of all pension inputs made during the pension input period ending in the year. It is not available "per pension".

The lifetime allowance is available only once. If the lifetime allowance is partly used when one pension fund vests, the remainder of the lifetime allowance can be used when benefits are taken from the other pension fund(s). FA 2004, s.219

Once the lifetime allowance is fully used, any further pension benefits will be automatically subject to the lifetime allowance charge as calculated above.

To calculate how much of the lifetime allowance (LA) is remaining on the vesting of a second (or subsequent) pension, we use the following formulae:

Remaining LA = LA for year of vesting – LA previously used

where **LA previously used** $= \dfrac{\textbf{Amount previously vested}}{\textbf{LA at previous vesting}} \times$ **Current LA**

Therefore, if for example 25% of the then lifetime allowance was utilised when the first pension vested, 75% of the current lifetime allowance will be available when a subsequent pension vests.

Illustration 6

Diane has 2 pensions. She was self-employed for 25 years and in that period she made contributions to a personal pension scheme. For the last 15 years she has been employed and has been making contributions to an occupational money purchase scheme.

Diane semi-retired on 1 January 2010 and from that date she started to draw benefits from her personal pension. That fund was worth £1.4m at the time of vesting. The lifetime allowance in 2009/10 was £1.75m.

On 1 January 2011 she retired completely and started to draw benefits from her occupational pension. That fund was valued at £800,000 in January 2011. The lifetime allowance in 2010/11 is £1.8m.

2009/10

No lifetime allowance charge as capital value less than the 2009/10 limit of £1.75m.

2010/11

LA previously used = $\frac{1400000}{1750000} \times 1{,}800{,}000 = \underline{£1{,}440{,}000}$

Lifetime Allowance remaining = £1,800,000 – £1,440,000 = £360,000

Lifetime Allowance charge 2010/11:

	£
Pension fund vesting at 1.1.11	800,000
Less: lifetime allowance remaining	(360,000)
Excess fund	440,000

If we assume the excess is taken as a lump sum, the tax charge will be:

Tax @ 55%	**£242,000**

A simpler way to think about this is to say that in 2009/10, Diane's first pension was worth £1.4m (being 80% of the lifetime allowance of £1.75m). She therefore has 20% of her lifetime allowance to use when her second pension vests. This vests in 2010/11 when the lifetime allowance is £1.8m. The lifetime allowance remaining in 2010/11 is therefore 20% x £1.8m = £360,000.

29.7 Transitional provisions and protection

There are **two types of protection** for members of pension schemes in relation to the lifetime allowance charge. These are called **primary protection** and **enhanced protection.** Protection applies for taxpayers with interests in pension funds at 6 April 2006, i.e. funds in existence prior to the introduction of the current pension regime. FA 2004 Sch 36 para 1

Primary Protection

Primary protection applies where a member of a pension scheme had pension rights **in excess of £1.5m** at 6 April 2006. These are called "**pre-commencement** rights". In this case, the lifetime allowance will be uplifted when it comes to calculating any lifetime allowance charge in future years. FA 2004, Sch 36 paras 7 - 11

This uplift is done using the following formulae:

Revised LA = LA for year of vesting x "Primary Protection factor" (PPF)

Where

$$\textbf{PPF} = \frac{\textbf{Pension rights @ 6 April 2006} - \textbf{LA 2006/07}}{\textbf{LA 2006/07}} + \textbf{1}$$

The lifetime allowance for 2006/07 was £1.5m.

In simple terms, if, say, an individual has a pension fund worth £3m at April 2006, this is **double** the lifetime allowance for 2006/07. Therefore when he draws benefits from his pension fund at a later date, the lifetime allowance for the year of vesting is also doubled to calculate any lifetime allowance charge.

Illustration 7

Matthew has an occupational pension. The value of his accrued rights at 6 April 2006 total £1.8m. He retired in March 2011 and thereafter drew his pension.

His lifetime allowance for 2010/11 will therefore be as follows:

$$\text{Primary Protection Factor} = \frac{£1.8\text{m} - £1.5\text{m}}{£1.5\text{m}} = 0.2 + 1 = \underline{1.2}$$

$$\text{Lifetime Allowance 2010/11} = £1.8\text{m} \times 1.2 = \underline{£2.16\text{m}}$$

Only if the value of Matthew's pension benefits exceed £2.16m in March 2011 will he have a lifetime allowance charge.

Individuals were required to register with HMRC if they wished primary protection to apply. This registration had to be made no later than 5 April 2009.

Enhanced protection

Enhanced protection is available for all taxpayers, even those with funds below the lifetime allowance. FA 2004, Sch 36 paras 12 - 17

If an individual registers for enhanced protection, his pension fund will not be subject to the lifetime allowance when the fund vests, irrespective of its value at that time. However, no further contributions are permitted to be made to the fund after April 2006. Any contribution to the fund after April 2006 will invalidate the enhanced protection and leave the fund liable to the lifetime allowance charge

Registration for enhanced protection also had to be made no later than 5 April 2009. Individuals could register for both primary and enhanced protection.

29.8 When can benefits be drawn?

Authorised payments (i.e. payments which can be made under tax privileged rules) can only be made from a pension scheme once the taxpayer has reached the "minimum retirement age". From 6 April 2010, the minimum retirement age is 55. FA 2004, S.279

Unauthorised payments can be taken at any time, but these will be subject to a tax charge.

Individuals do not have to "retire" to draw benefits from a pension scheme. Also individuals do not necessarily have to take all their pension benefits at the same time – some can be deferred to a later date.

29.9 Non-registered schemes

These schemes are known as Employer Financed Retirement Benefit Schemes (EFRBS).

Such schemes are typically set up by employers to "top-up" retirement benefits for senior employees, executives and directors where annual pension input is often well in excess of the annual allowance, or where the capital value of the fund is high enough to create a lifetime allowance charge. To provide "top-up" benefits, an employer may establish an EFRBS.

The main difference between an EFRBS and a registered scheme is the **denial of certain tax advantages** for an EFRBS.

Employer contributions to an EFRBS on behalf of an employee are not taxable benefits for the employee. However, employee contributions to an EFRBS do not attract any tax relief. It is unusual for employees to make any contributions, and EFRBS often prohibit such contributions and accept payments only from the employer.

Employer contributions to an EFRBS will only be deductible as a trading expense for the employer if they satisfy the "wholly and exclusively" test. However, relief for employer contributions **will not be given until the period in which the employee draws the benefits** (which could be many years after the expense was incurred).

Income and gains in the fund will be taxed at 40% (32.5% for dividends).

Lump sums paid to an employee on retirement will be subject to income tax as employment income. ITEPA 2003, s. 394

Example 1

Rahul is a member of his employer's final salary scheme. At the beginning of the pension input period ending in 2010/11, he had been with his employer for 14 years and his salary was £210,000. At the end of the period, he had 15 years service and a salary of £260,000. His pension accrual rate is 1/30.

Calculate the annual allowance charge (if any) for 2010/11.

Example 2

Natalie started drawing benefits from her occupational scheme when she left her employer company on 1 June 2009. Her pension benefits were then valued at £656,250.

She continues to act as a freelance consultant. She intends to retire on her 65th birthday in August 2011, at which point she will draw a pension from her personal pension scheme. The insurance company estimates that this fund will be worth around £2m at that point. She will take any unauthorised pension fund as a lump sum. Assume the lifetime allowance in 2011/12 will be £1.8m.

Calculate the lifetime allowance charge which will arise in 2011/12.

Example 3

Mr Wilkins, has relevant income of £390,000 in 2010/11. In previous years he has contributed £5,000 on the 15th of each month to his personal pension but decided to increase this to £6,000 per month in 2010/11.

Calculate the amount of the special annual allowance charge in 2010/11.

Answer 1

Value of rights at tend of pension input period	£
15/30 x £260,000 x 10	1,300,000
Less:	
Value of rights at start of pension input period	
14/30 x £210,000 x 10	(980,000)
Pension input amount	£320,000
	£
Pension input amount	320,000
Less: annual allowance	(255,000)
	£65,000
Annual allowance charge	
£65,000 @ 40%	£26,000

Answer 2

2009/10

No lifetime allowance charge as capital value less than the 2009/10 limit of £1.75m.

2011/12

Previously used LA $\frac{656250}{1750000} \times 1{,}800{,}000 = \underline{£675{,}000}$

Lifetime allowance remaining = £1,800,000 – £675,000 = £1,125,000

Lifetime Allowance charge 2011/12

	£
Pension fund vesting at August 2011	2,000,000
Less: lifetime allowance remaining	(1,125,000)
Excess fund	875,000
Tax @ 55%	**£481,250**

Answer 3

$£(1{,}000 \times \frac{100}{80}) \times 12 = 15{,}000$ @ 30% = £4,500.

Tutorial Note:

Mr Wilkins regular pension savings are £75,000 per annum $((5{,}000 \times \frac{100}{80}) \times 12)$.

As this clearly exceeds £20,000, the full amount of the increase will be subject to the special annual allowance charge. The charge is calculated at 30% as Mr Wilkins is an additional rate taxpayer.